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IN THE

Supreme Court of the United States

OCTOBER TERM, 1954

No. [redacted] 90

CORN PRODUCTS REFINING COMPANY,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Corn Products Refining Company prays that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered in the above entitled consolidated cases on the 25th day of August, 1954. A petition for rehearing was denied September 27, 1954.

Citation to Opinions Below

The two opinions of The Tax Court in these consolidated proceedings involve Federal income taxes for the calendar year 1940 and Federal income and excess profits taxes for the calendar year 1942, and the composition of the excess profits credit for such years based on income. The opinion for the year 1940 appears in 16 T. C. 395 and printed in Appendix B hereof, *infra*, page 52.

The Memorandum opinion of The Tax Court, dated June 30, 1952, involving the calendar year 1942 is also printed in Appendix B hereof, *infra*, page 33.

The opinion of the United States Court of Appeals is printed in Appendix B hereof, *infra*, page 48, and is reported in 215 F. (2d) 513.

Jurisdiction

The judgment of the Circuit Court of Appeals was entered on August 25, 1954. Rehearing was denied on September 27, 1954. The jurisdiction of this Court is invoked under 28 U. S. C. Section 1254(1). A single writ of certiorari is sought in the consolidated cases under Rule 23(5) of the Rules of this Court.

Questions Presented

Four separate and distinct questions are presented for review. The tax year involved is indicated in connection with each question.

I

Commodity Futures Transactions

Are transactions in commodity futures which are not "true hedges" capital asset transactions and thus subject to the limitations of Section 117 of the Internal Revenue Code of 1939, or do the resulting gains and losses from such transactions give rise to ordinary income and ordinary deductions? (1940) (1942)

II

Wash Sales

Are commodity futures contracts "securities" and thus subject to the "wash sales" provisions of Section 118 of the Internal Revenue Code of 1939? (1940) (1942)

III

Foreign Dividends

Where parts of foreign dividends, subject to foreign government currency control restrictions, were converted to dollars, does the remainder which was actually used in the foreign country constitute taxable income? (1942)

IV

Jurisdiction of This Court and of the Court of Appeals

Does Section 732(c) of the Internal Revenue Code o 1939 take away the jurisdiction of the Appellate Courts to review Tax Court decisions under Section 710(c) of the Internal Revenue Code of 1939 relating to carry-overs of unused excess profits credits where such carry-overs are affected by income previously determined for 1941 and stipulated herein to be "abnormal" under Section 721 of said Code? (1942)

Statutes Involved

The statutory provisions involved are as follows:

With respect to question I, Section 117 of the Internal Code of 1939;

With respect to question II, Section 118 of the Internal Revenue Code of 1939;

With respect to question IV, Sections 710, 721, and 732(c) of the Internal Revenue Code of 1939.

They are printed in Appendix A, *infra*, pages 17-24.

Statement

The basis of the jurisdiction of the court of first instance, The Tax Court of the United States, was in each case, a petition filed by the taxpayer pursuant to Section 272 of the Internal Revenue Code of 1939.

The case with respect to each of the questions presented is as follows:

I

Commodity Futures Transactions

Petitioner's contention is that the commodity futures transactions were capital asset transactions since they were not "true hedges".

The Court of Appeals held that even though the transactions were not "true hedges", they gave rise to ordinary income and ordinary losses.

The facts pertaining to this question are as follows:

Petitioner is a nationally-known corporation engaged in the manufacture and sale of products derived from corn (R. 66, 606). Its own plants could store 2,303,000 bushels or less than three weeks' supply of corn (R. 67, 607). In 1937, as a result of losses previously sustained due to drought, a plan was envisaged whereby petitioner would buy corn futures whenever it considered the price of corn low, with the purpose of establishing a long futures position in the neighborhood of 12,000,000 bushels (R. 70). This position was never attained (R. 70), although substantial quantities of corn futures were acquired (R. 71). In 1939, the outbreak of the European War made this plan unnecessary (R. 71).

The corn futures contracts were not sold to customers in the regular course of petitioner's business but were disposed of, with minor exceptions, through brokers on regulated exchanges; nor were such contracts included in inventory, nor were they subject to depreciation (R. 272, 612).

Under petitioner's general sales policy, contracts were entered into with its customers for shipment within thirty days (R. 607-608). The price was named but provision was made that if the price in effect on the day of delivery was lower the buyer was to have the advantage of such lower price (R. 607-608). This made a true hedge mathematically impossible. Petitioner also had the policy of permitting its customers to cancel their orders in their discretion (R. 608). Cancellations were frequent and unpredictable (R. 75, 207). This made any balancing of customers orders against purchases of futures contracts impossible. Petitioner was not protected against price declines as it would have been under a "true hedge".

II

Wash Sales

Petitioner contends that its corn futures transactions were subject to the wash sales provisions of Section 118 of the Internal Revenue Code of 1939. The Court of Appeals held that they were not.

The facts pertaining to this question are as follows:

A corn future consists of a contract to deliver 5,000 bushels of corn, or some multiple thereof, of a stated quality, at a stated price, for delivery during a stated month in the future (R. 68, 610). Such contracts called for delivery within eleven months or less from the date of contract (R. 68, 610). Such contracts are freely dealt with on regulated commodity exchanges through brokers (R.

69). The buyer of a futures contract furnishes his broker with margin (R. 69). These contracts were acquired and disposed of, with minor exceptions, through brokers on regulated exchanges in the same manner that stocks and bonds were dealt in on the same exchanges (R. 272 and 280).

III

Foreign Dividends

Petitioner contends that it had reportable income from Italian and Brazilian dividends during the year 1939. The result of such treatment would increase its excess profit credit and its unused excess profit credits carry-overs.

The facts pertaining to this question are as follows:

During 1939, petitioner had certain subsidiaries in Brazil and Italy (R. 618 and 621). In December, 1938, Maizena, Brazil, S. A., a wholly-owned subsidiary, declared a dividend in the amount of 2,175,000$000 Brazilian milreis, which was paid on January 13, 1939 (R. 619). Petitioner actually received the dollar equivalent in the United States of 100,649$900 milreis in 1939 (R. 621). Petitioner lent the balance of the dividend paid by Maizena, to another wholly-owned subsidiary operating in Brazil, Refinacoes de Milho, Brazil, a New Jersey corporation (R. 750, 769, 770).

In 1939, various Italian corporations declared and paid dividends in the sum of 4,496,327 lire to petitioner, a stockholder thereof (R. 622-623). During the year 1939, petitioner actually converted 410,000 lire of dividend income to dollars at 2.1¢ per lira (R. 624). Upon the payments of dividends the monies were either deposited in Italian bank accounts at interest to the credit of petitioner (R. 765-766) or were loaned to other Italian subsidiaries of petitioner for use by them (R. 759).

The Court of Appeals decided in favor of the Government that the dividends were not taxable income, stating that the petitioner had not sustained the burden of "proof of free convertibility".

IV

Jurisdiction of This Court and of the Court of Appeals

Petitioner contends that the Court of Appeals has jurisdiction to review the determination of The ~~Tax~~ Court with respect to an unused excess profits credit carry-over computed under Section 710(c) of the Internal Revenue Code and that nothing under Section 732(c) deprives the Court of that jurisdiction. The Court of Appeals held that it lacked jurisdiction.

The facts pertaining to this question are as follows:

In the year 1941 petitioner had no excess profits tax liability (R. 676). It did, however, have $436,945.36 of conceded abnormal income in that year attributable under Section 721 to pre-excess profits tax years (R. 630, 675). Respondent in computing the unused excess profits credit carry-over under Section 710(c) from 1941 to 1942 refused to exclude the amount of the 1941 abnormal income, *i. e.*, $436,945.36 from petitioner's 1941 excess profits net income. As a consequence the unused excess profits credit carry-over from 1941 was not increased by that amount (R. 630).

Reasons for Granting the Writ

I. On the Question Whether the Petitioner's Transactions in Commodity Futures Contracts Gave Rise to Capital or Ordinary Gains and Losses

A. There Is a Conflict Among Circuits.

The decision of the Court of Appeals to the effect that petitioner's transactions in corn futures gave rise to ordi-

nary income and deductions is in direct conflict with decisions of three other Courts of Appeals. *Estate of Dorothy Makransky et al.* v. *Commissioner* (3rd Cir.—1946), 154 F. (2d) 59, affirming 5 T. C. 397; *Commissioner* v. *Farmers & Ginners Cotton Oil Co.* (5th Cir.—1941), 120 F. (2d) 772, reversing B. T. A. Memo., Docket No. 93436 (March 3, 1942); *Trenton Cotton Oil Co.* v. *Commissioner* (6th Cir.—1945), 147 F. (2d) 33, reversing T. C. Memo., Docket No. 110950 (December 28, 1943); all of which decisions are printed in Appendix C, page 57 and *ff.*

In the *Makransky* case, the taxpapers, wool converters, fearing a shortage of wool because of the impact of World War II, purchased wool top futures contracts equivalent to approximately three quarters of their estimated annual requirements in an attempt to assure themselves of a supply. Losses on the subsequent sales of these futures contracts were held to be capital losses.

The other two cases cited involved similar fact patterns, and the decisions were to the same effect.

The Court of Appeals in the instant case was not unaware of the above cited cases. Indeed, it referred to them directly. It noted the inconsistency between the position of the Commissioner of Internal Revenue in those cases and in the instant case, saying (p. 1791):

> "However, from 1940 to 1946 the Commissioner successfully contended in a series of instances [citing the cases above mentioned] that dealings in commodity futures contracts gave rise to capital rather than ordinary gains and losses . . ."

The Court, however, made no attempt whatsoever to distinguish them. It is submitted that the instant case cannot be distinguished.

The decisions in each of the three cited cases turned on the finding that the taxpayer's commodity futures trans-

actions did not constitute a "true hedge". In the instant case, the Court of Appeals specifically stated that the petitioner's commodity futures transactions did not constitute a "true hedge", saying (p. 1794):

> "The future transactions of this petitioner it is true did not constitute what is known as 'true' hedging. The true hedge can occur only when forward sales prices are fixed and the relation between commodity purchase and later sales price is insured against both increase and decrease of commodity prices. As the forward sales prices here were based mainly on the lower of order or market prices, the petitioner was protected only against increases in commodity prices and did not have the complete insurance of the true hedge."

Contrary to the rationale of the three cited cases, however, the Court in the instant case came to the completely opposite decision.

The three cases cited above and the instant case contain the following salient elements in common:

(1) All cases involved commodity futures transactions.

(2) In all cases the transactions were an integral part of the way of doing business of the taxpayer.

(3) In all cases the transactions were entered into with a view to protecting the ordinary profits of the taxpayer.

(4) In all cases the Courts found that there was not a "true hedge", *i. e.*, no balanced position and no protection against price declines.

In the three cited cases the transactions of the taxpayers were treated as capital asset transactions. In the instant case the transactions of the petitioner were treated as ordinary transactions. The conflict between the Circuits should be resolved, so that application of the law

will be uniform throughout the United States as required by Article I, Section 8, Clause 1 of the Constitution, and so that the inconsistent positions taken by the respondent will be eliminated for the future.

B. An Important Question of Federal Law Not Heretofore Decided by This Court Is Involved.

Although the instant case arose under the Internal Revenue Code of 1939, the question still remains of continuing importance under the Internal Revenue Code of 1954 (Section 1233).

Moreover, the prevalence and vast dollar volume of commodity futures trading on regulated exchanges in the United States is well known.* As a consequence, a decision on the question involved is one that will have an important impact on both taxpayers and the revenue of the United States.

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* *Statistical Abstract of the United States* — 1953, page 459.

No. 509.—Principal Commodity Futures—Volume of Trading on All Contract Markets: 1940-41 to 1951-52

(Compiled from daily reports of all clearing members of each contract market)

Year Beginning July	Wheat (million bushels)	Corn (million bushels)	Oats (million bushels)	Rye (million bushels)	Soybeans (million bushels)	Cotton (thousand bales)	Eggs (carlots)
1940-41	4,783.9	795.8	248.5	266.2	611.4	34,258	46,903
1941-42	3,831.0	1,235.6	524.0	790.0	681.6	64,903	41,975
1942-43	2,703.2	851.3	610.6	1,469.7	16.0	42,738	9,005
1943-44	2,641.7	(1)	726.4	3,031.1	(1)	39,170	6,085
1944-45	2,425.0	491.3	1,090.2	3,978.6	(1)	37,813	40,729
1945-46	1,474.0	117.6	2,438.8	1,963.5	(1)	60,353	79,357
1946-47	2,322.4	2,608.9	3,905.6	.2	(1)	110,248	135,325
1947-48	5,768.1	3,798.8	2,668.6	21.1	40.2	110,583	125,020
1948-49	4,514.9	3,678.3	1,175.7	125.4	1,537.7	63,385	91,191
1949-50	4,202.0	2,013.4	1,048.2	581.6	3,613.9	52,697	56,938
1950-51	4,675.7	2,236.6	1,617.3	576.2	2,952.6	79,067	148,811
1951-52	4,341.7	2,639.6	2,239.2	426.6	2,953.2	94,887	90,005

1 Trading suspended.

Source: Deparment of Agriculture, Commodity Exchange Authority; annual report, *Commodity Futures Statistics*.

II. On the Question Whether Commodity Futures Contracts Are Securities and So Subject to the Wash Sales Provisions of Section 118 of the Internal Revenue Code of 1939

A. There Is a Conflict Between Circuits.

The decision of the Court of Appeals in the instant case, in direct conflict with *Trenton Cotton Oil Co.* v. *Commissioner* (6th Cir.—1945), 147 F. (2d) 33, held that commodity futures were not securities and consequently that transactions in them were *not* subject to the wash sales provisions of Section 118 of the Internal Revenue Code of 1939. In *Trenton Cotton Oil Co.* v. *Commissioner, supra*, the Sixth Circuit had held that commodity futures were securities and consequently that transactions in them *were* subject to the wash sales provisions.

This conflict between the Circuits was expressly recognized by the Court below in its opinion (Appendix B, *infra*, p. 53), where it stated:

> "The petitioner's further contention that the wash sales provision of Section 118 is applicable to its futures transactions rests on *Trenton Cotton Oil Co.* v. *Commissioner* (6th Cir.—1945) 147 F. (2d) 33, rehearing denied 148 F. (2d) 208. With deference, however, we find ourselves unable to agree with that decision. *Cf. Harriss* v. *Commissioner* 2nd Cir., 143 F. (2d) 279; *Valley Waste Mills* 5th Cir., 115 F. (2d) 466, cert. denied 312 U. S. 681."

The conflict between the Circuits should be resolved so that the application of the law will be uniform throughout the United States as required by Article I, Section 8, Clause 1 of the Constitution.

B. An Important Question of Federal Law Not Heretofore Decided by This Court Is Involved.

The importance of this question was recognized by the Court of Appeals in *Trenton Cotton Oil Co.* v. *Commissioner, supra* (p. 37), when it used the following language:

> "The sole purpose of the statute was to prevent the deduction of losses from net income and the Congress set up as a barrier a more or less arbitrary standard to overcome the evil. Unless losses from dealings in commodity futures through a broker are within the statute, the barrier is weakened, because the dealings in such property on exchanges of the country are almost as extensive as that in stocks and bonds."

Although the instant case arose under the Internal Revenue Code of 1939, the question still remains of importance under the Internal Revenue Code of 1954 (Section 1091).

Moreover, the prevalence and vast dollar volume of commodity futures trading in the United States (see statistical material, p. 10, *supra*) makes a decision on the question involved one of very real importance to both taxpayers and the revenue of the United States.

III. On the Question Whether the Petitioner Had Income from Foreign Dividends

The decision of the court below in the instant case is in apparent conflict with the decision of the Third Circuit in *Richard Whitney* v. *Commissioner* (3rd Cir.—1934), 73 F. (2d) 589.

In the instant case the taxpayer urged that it had income from foreign dividends in 1939. It showed that the dividends were declared and paid in a foreign currency,

that it was able to and did convert a portion of its Brazilian and Italian funds at a price, and it actually used the balance for corporate purposes in the foreign countries. The court below held in respect of the balance of the dividends actually used abroad for corporate purposes that the taxpayer did not have income, refusing to recognize upon this showing that the burden of going forward with proof that the taxpayer did not have income in 1939 shifted from the taxpayer to the Commissioner. Respondent offered no proof whatever on this issue.

In the *Whitney* case, *supra*, the Third Circuit recognized that once petitioner had come forward with proof to establish its contention, the burden of going forward shifted to the respondent. It is believed that the decision of the court below in failing to recognize this rule of law is erroneous and creates a conflict. The question is one of broad application in the trial of Tax Court cases.

IV. On the Question of the Jurisdiction of This Court and the Court of Appeals

A. There Is a Conflict Among Circuits.

The decision of the Court below that it did not have jurisdiction because of Section 732(c) to determine under Section 710(c) the carry-over of unused excess profits credit is in conflict with the decisions of three Courts of Appeals, *Stimson Mill Company* v. *Commissioner* (9th Cir.—1947), 163 F. (2d) 269; *Dowd-Feder, Inc.* v. *Commissioner* (6th Cir.—1949), 173 F. (2d) 673, and *Packer Publishing Co.* v. *Commissioner* (8th Cir.—1954), 211 F. (2d) 612. The three Circuit Court decisions cited above have all permitted taxpayers to appeal to the Circuit Court in cases involving excess profits issues where the question does not arise *solely* by reason of Section 711, Section 721, or Section 722.

The Court below held that it had no jurisdiction to consider the effect of petitioner's abnormal income realized in 1941 on its unused excess profits credit carry-over from the same year. While it is true that the jurisdiction of The Tax Court is final in cases arising *solely* by reason of Section 721, the issue in the instant case concerns itself, not *solely* with Section 721, but with Section 710(c).

The Court below has overlooked, in interpreting the statute, the word "solely". If a decision involves only Section 721 or Section 722, the Court of Appeals has no jurisdiction to review The Tax Court. *George Kemp Real Estate Company* v. *Commissioner* (2nd Cir.—1950), 182 F. (2d) 1947; *James E. Waters, Inc.* v. *Commissioner* (9th Cir.—1947), 160 F. (2d) 596. Consequently, where the question before the Court, as in the present case, does not challenge the Commissioner's determination with respect to Section 721 since the net abnormal income was conceded, the question cannot arise solely by reason of that section within the meaning of Section 732(c). The only question actually before the Court was the computation of the correct carry-over of unused excess profits credit, and that question is determined by Section 710(c).

The petitioner in 1941 had received $436,945.36 of abnormal income within the meaning of Section 721. This is conceded by the Commissioner and is nowise in question in this case. The question at issue is the proper treatment of this abnormal income for purposes of computing petitioner's unused excess profits credit carry-over. This is to be determined under Section 710(c) and not under Section 721, which latter Section does not deal with credit carry-overs.

B. An Important Question of Federal Law Not Heretofore Decided by This Court Is Involved.

This question is one of importance because of the large volume of excess profits relief claims still pending

both before the Treasury and before The Tax Court of the United States, and the conflict of decisions accordingly should be resolved so that the application of the statute will be uniform throughout the United States as required by Article I, Section 8, Clause 1 of the Constitution.

CONCLUSION

For the foregoing reasons this Petition for a Writ of Certiorari should be granted.

Respectfully submitted,

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Dated: November 19, 1954.

APPENDIX A

Internal Revenue Code of 1939

"SEC. 117. CAPITAL GAINS AND LOSSES.

"(a) *Definitions.*—As used in this chapter—

"(1) *Capital Assets.*—The term 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

"(A) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

"(B) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l), • • •

• • • •".

"SEC. 118. LOSS FROM WASH SALES OF STOCK OR SECURITIES.

"(a) In the case of any loss claimed to have been sustained from any sale or other disposition of shares of stock or securities where it appears that, within a period beginning 30 days before the date of such sale or disposition and ending 30 days after such date, the taxpayer has acquired (by purchase or by an exchange upon which the entire amount of gain or loss was recognized by law), or has entered into a contract or option so to acquire, substantially identical stock or securities, then no deduction for the loss shall be allowed under section 23(e) (2); nor shall such deduction be allowed under section 23(f) unless the claim is made by a corporation, a dealer in stocks or

securities, and with respect to a transaction made in the ordinary course of its business.

* * * *"

"SEC. 710. IMPOSITION OF TAX.

* * * *

"(c) Unused Excess Profits Credit Adjustment.—

"(1) *Computation of Unused Excess Profits Credit Adjustment.*—The unused excess profits credit adjustment for any taxable year shall be the aggregate of the unused excess profits credit carry-overs and unused excess profits credit carry-backs to such taxable year.

"(2) *Definition of Unused Excess Profits Credit.*—The term 'unused excess profits credit' means the excess, if any, of the excess profits credit for any taxable year beginning after December 31, 1939, over the excess profits net income for such taxable year, computed on the basis of the excess profits credit applicable to such taxable year. For such purpose the excess profits credit and the excess profits net income for any taxable year beginning in 1940 shall be computed under the law applicable to taxable years beginning in 1941. * * *"

"SEC. 721. ABNORMALITIES IN INCOME IN TAXABLE PERIOD.

"(a) *Definitions.*—For the purpose of this section—

"(1) *Abnormal Income.*—The term 'abnormal income' means income of any class includible in the gross income of the taxpayer for any taxable year under this subchapter if it is abnormal for the taxpayer to derive income of such class, or, if the taxpayer normally derives income of such class but the

amount of such income of such class includible in the gross income of the taxable year is in excess of 125 per centum of the average amount of the gross income of the same class for the four previous taxable years, or, if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence.

"(2) *Separate Classes of Income.*—Each of the following subparagraphs shall be held to describe a separate class of income:

"(A) Income arising out of a claim, award, judgment, or decree, or interest on any of the foregoing; or

* * * *

"(C) Income resulting from exploration, discovery, prospecting, research, or development of tangible property, patents, formulae, or processes, or any combination of the foregoing, extending over a period of more than 12 months; or

"(D) Income includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's accounting period or method of accounting; or

"(E) In the case of a lessor of real property, income included in gross income for the taxable year by reason of the termination of the lease; or

"(F) Income consisting of dividends on stock of foreign corporations, except foreign personal holding companies.

All the income which is classifiable in more than one of such subparagraphs shall be classified under the one which the taxpayer irrevocably elects. The classification of income of any class not described in

subparagraphs (A) to (F), inclusive, shall be subject to regulations prescribed by the Commissioner with the approval of the Secretary.

"(3) *Net Abnormal Income.*—The term 'net abnormal income' means the amount of the abnormal income less, under regulations prescribed by the Commissioner with the approval of the Secretary, (A) 125 per centum of the average amount of the gross income of the same class determined under paragraph (1), and (B) an amount which bears the same ratio to the amount of any direct costs or expenses, deductible in determining the normal-tax net income of the taxable year, through the expenditure of which such abnormal income was in whole or in part derived as the excess of the amount of such abnormal income over 125 per centum of such average amount bears to the amount of such abnormal income.

"(b) *Amount Attributable to Other Years.*—The amount of the net abnormal income that is attributable to any previous or future taxable year or years shall be determined under regulations prescribed by the Commissioner with the approval of the Secretary. In the case of amounts otherwise attributable to future taxable years, if the taxpayer either transfers substantially all its properties or distributes any property in complete liquidation, then there shall be attributable to the first taxable year in which such transfer or distribution occurs (or if such year is previous to the taxable year in which the abnormal income is includible in gross income, to such latter taxable year) all amounts so attributable to future taxable years not included in the gross income of a previous taxable year.

"(c) *Computation of Tax for Current Taxable Year.*—The tax under this subchapter for the taxable year, in

which the whole of such abnormal income would without regard to this section be includible, shall not exceed the sum of:

"(1) The tax under this subchapter for such taxable year computed without the inclusion in gross income of the portion of the net abnormal income which is attributable to any other taxable year, and

"(2) The aggregate of the increase in the tax under this subchapter for the taxable year (computed under paragraph (1)) and for each previous taxable year which would have resulted if, for each previous taxable year to which any portion of such net abnormal income is attributable, an amount equal to such portion had been included in the gross income for such previous taxable year.

"(d) *Computation of Tax for Future Taxable Year.*— The amount of the net abnormal income attributable to any future taxable year shall, for the purposes of this subchapter, be included in the gross income for such taxable year:

"(1) The tax under this subchapter for such future taxable year shall not exceed the sum of—

"(A) the tax under this subchapter for such future taxable year computed without the inclusion in gross income of the portion of such net abnormal income which is attributable to such year, and

"(B) the decrease in the tax under this subchapter for the previous taxable year in which the whole of such abnormal income would, without regard to this section, be includible which resulted by reason of the computation of such tax for such previous taxable year under the provisions of subsection (c); but the amount of such decrease shall

be diminished by the aggregate of the increases in the tax under this subchapter for the future taxable year as computed under subparagraph (A) and for the taxable years intervening between such previous taxable year and such future taxable year which have resulted because of the inclusion of the portions of such net abnormal income attributable to such intervening years in the gross income for such intervening years.

"(2) If, in the application of subsection (c), net abnormal income from more than one taxable year is attributable to any future taxable year, paragraph (1) of this subsection shall be applied with respect to such future taxable year in the order of the taxable years from which the net abnormal income is attributable beginning with the earliest, as if the portion of the net abnormal income from each such year was the only amount so attributable to such future taxable year, and (except in the case of the portion for the earliest previous taxable year) as if the tax under this subchapter for the future taxable year was the tax determined under paragraph (1) with respect to the portion for the next earlier previous taxable year.

"(3) If in the application of paragraph (1) to any future taxable year it is determined that the decrease in tax computed under paragraph (1) (B) with respect to the net abnormal income, a portion of which is included in the gross income for the future taxable year, does not exceed the aggregate of the increases in tax computed under paragraph (1) (B) with respect to such net abnormal income, then the portions of such net abnormal income attributable to taxable years subsequent to such future taxable year shall not be included in the gross income for such subsequent taxable years. For the purpose of computing

the tax under this subchapter for a taxable year subsequent to the future taxable year, the portion of net abnormal income attributable to the future taxable year shall not be included in the gross income for such future taxable year to the extent that the inclusion of such portion of net abnormal income in the gross income for such future taxable year did not result in an increase in tax for such future taxable year by reason of the provisions of paragraph (1).

"(e) *Application of Section.*—This section shall be applied only for the purpose of computing the tax under this subchapter as provided in subsections (c) and (d), and shall have no effect upon the computation of base period net income. For the purposes of subsections (c) and (d)—

"(1) Net abnormal income means the aggregate of the net abnormal income of all classes for one taxable year.

"(2) Under regulations prescribed by the Commissioner with the approval of the Secretary, the tax under this subchapter for previous taxable years shall be computed as if the portions of net abnormal income for each previous taxable year for which the tax was computed under this section were included in the gross income for the other previous taxable years to which such portions were attributable.

"(3) If both subsections (c) and (d) are applicable to any current taxable year, subsection (d) shall be applied without regard to subsection (c), and subsection (c) shall be applied as if the tax under this subchapter, except for subsection (c), was the tax computed under subsection (d) and as if the gross income and the other amounts necessary to determine the adjusted excess profits net income were those

amounts which would result in the tax computed under subsection (d).

"(f) *Abnormal Income From Exploration, Etc.*—If by reason of taking into account, in determining constructive average base period net income under section 722, exploration, discovery, prospecting, research, or development of tangible property, patents, formulae, or processes, or any combination of the foregoing, extending over a period of more than 12 months, such constructive average base period net income is higher than it would be without such taking into account, only such portion of the income in the taxable year resulting from such activity which is of a class described in subsection (a) (2) (C) as is attributable to another taxable year under this subchapter shall be deemed attributable to a year other than the taxable year."

"SEC. 732. REVIEW OF ABNORMALITIES BY BOARD OF TAX APPEALS [NOW THE TAX COURT OF THE UNITED STATES].

* * * *

"(c) *Finality of Determination.*—If in the determination of the tax liability under this subchapter the determination of any question is necessary solely by reason of section 711 (b) (1) (H), (I), (J), or (K), section 721, or section 722, the determination of such question shall not be reviewed or redetermined by any court or agency except the Board.

* * * *"

APPENDIX B

CORN PRODUCTS REFINING CO., PETITIONER, v. COMMISSIONER OF INTERNAL REVENUE

Docket No. 20399. February 20, 1951.

WASH SALES — SECURITIES — SUBSTANTIALLY IDENTICAL — COMMODITY FUTURES — SECTION 118.—Contracts for the delivery of corn for a stated price at a stated future time are not securities within the meaning of section 118 and one such contract is not substantially identical with another where the date for delivery is different and the contract price and the other contracting party may be different.

Jay O. Kramer, Esq., for the petitioner.

Walt Mandry, Esq., for the respondent.

The Commissioner determined a deficiency of $163,804.78 in the income tax of the petitioner and an affiliate for 1940. The issues in dispute are whether profits and losses of the petitioner resulting from purchases and sales of corn futures are capital gains and losses within the meaning of section 117 and, second, whether the wash sales provisions of section 118 apply to those transactions.

FINDINGS OF FACT.

The petitioner filed a consolidated corporate income tax return for 1940 with the collector of internal revenue for the second district of New York.

The petitioner is a nationally known corporation engaged in the manufacture and sale of corn products, including starches, sugars, syrups, oils, and feeds.

The maximum amount of raw corn which the petitioner could store in its own plants during 1940 was 2,303,000 bushels. That quantity would keep it supplied for less than three weeks. The daily grind capacity of the plants

of the petitioner during 1940 was 147,700 bushels. Similar conditions existed in prior years.

The principal product obtained by the petitioner from raw corn is starch. Cerelose is a refined sugar derived from starch. It competes with cane and beet sugars, but at a lower price, and constituted 15.93 per cent of the total sales of the petitioner in 1940.

A corn future consists of a contract to buy 5,000 bushels of corn, or some multiple thereof, of a stated quality, at a stated price, during a stated month in the future. The contracts involved were for delivery at a stated time within eleven months or less of the date of the contract. The party contracting to furnish the corn has the option of delivering the corn on any day during the month in which the contract matures and has the option of furnishing a different grade of corn at an appropriate adjustment in price. The transactions are made through a broker on a commodity exchange. The buyer furnishes his broker with a percentage, or margin, of the contract price of the corn until delivery is taken or the contract is sold, at which time final settlement is made. The contracts are freely dealt in on the commodity exchange.

The petitioner began to buy and sell corn futures in 1932 and continued that practice through 1940. It engaged in those futures transactions as a part of its corn buying program and as the most economical method of obtaining an adequate supply of [illegible] corn in view of its limited storage facilities and the expense of increasing those facilities sufficiently to take care of its needs. Purchases of futures were made when the price of corn was advantageously low.

High corn costs following droughts in 1934 and 1936 resulted in losses on cerelose sales made by the petitioner in 1937. The petitioner, in order to avoid or minimize similar losses, increased its buying of corn futures so

that it would have corn available at prices which permitted it to sell cerelose in competition with beet and cane sugar. It never reached its goal of a long position of 12,000,000 bushels.

The petitioner took delivery of corn on some of its future contracts, but usually sold most of its corn futures in early summer if it then appeared that there would be no shortage of corn and no great danger of increased prices, but if the crop was poor, or there was danger of an increase in price, it sold its futures gradually as it bought corn for grinding. The petitioner would begin to acquire additional futures contracts at harvest time each year.

The outbreak of World War II in 1939 raised the price of cane and beet sugars to such an extent that the petitioner no longer needed the futures to assist it in selling cerelose successfully in competition with those sugars. It owned futures at the beginning of 1940 for the purchase of over 8,000,000 bushels of corn. That long position was reduced, beginning in about June, so that, at the end of the year, it had futures covering only about 1,400,000 bushels.

It was the petitioner's practice to account for its profits or losses on corn futures in an account entitled "Corn Miscellaneous." The balance in that account, at the end of each year prior to 1940, was debited or credited to cost of sales and in 1940, the profit balance of $680,587.39 was used to reduce "Cost of Goods Sold."

The Commissioner, in determining the deficiency for 1940, made no change in "Cost of Goods Sold" as reported by the petitioner on its return.

The transactions in futures resulted in losses of $816,164.03 for 1938 and of $424,437.54 for 1939, and a net profit of $680,587.39 for 1940.

The following table shows for three years the futures purchased, those sold, and those under which delivery

was taken, together with the amount of corn purchased and received at the plants:

Year	Futures purchased		Futures sold		Futures under which delivery was taken		Bushels of Corn Purchased and Received at the plant
	Contracts	Bushels	Contracts	Bushels	Contracts	Bushels	Bushels
1938	824	19,675,000	755	17,400,000	192	4,975,000	35,650,77
1939	593	14,470,000	535	14,180,000	114	2,865,000	36,806,80
1940	437	8,125,000	728	14,595,000	24	250,000	37,222,40

The general sales policy of the petitioner, at all times material hereto, was to enter into contracts providing for shipment of the goods within thirty days and stating a definite price, but providing that the price should be that stated in the contract or the price in effect at date of delivery, whichever was lower. There were exceptions and variations to this general policy. One was that the petitioner, on January 15, 1940, invited all buyers to submit on or prior to January 20, orders for cerelose to be delivered as late as June 30, 1940. The buyer was guaranteed the lower of the January 15 price or the price in effect at date of delivery. The buyers were allowed to cancel all or parts of the amounts of the goods ordered. The petitioner received a great many orders in response to that invitation. Another exception was that the canning trade on the Pacific Coast was allowed to call on the petitioner for cerelose for delivery in more than thirty days. Cancellations were allowed in this situation also and the buyers were allowed the lower of the contract price or the price in effect at the date of delivery. The petitioner also agreed to furnish starch to two companies on what was, in effect, a cost plus basis.

The stipulation of facts is incorporated herein by this reference.

Appendix B

OPINION.

Murdock, *Judge:*

The parties have argued two points. One is whether contracts for the future delivery of corn are to be treated as capital assets in the hands of the petitioner so that gains or losses thereon are capital gains or losses, and the other is whether the wash sales provisions of section 118 apply to those transactions. The petitioner has not accounted for or reported its gains and losses from futures transactions as capital gains and losses but, on the contrary, treated the 1940 gains as a reduction in the cost of raw materials and the losses in prior years as an addition to the cost of goods sold. It thus reduced its income for prior years by the full amount of large losses sustained in those years on futures transactions and, being consistent, in 1940 reduced the cost of goods sold by the full amount of the 1940 gain. The Commissioner, in determining the deficiency, made no change in the taxpayer's treatment of the futures transactions and now insists that no change is necessary or proper. Nevertheless, the petitioner now seeks to have the transactions regarded as resulting in capital gains and losses within section 117.

Success on that point would have no effect on the tax liability in this case unless the second contention of the petitioner is also sustained. The petitioner sustained a short term capital loss of $5,718.27 on bonds and it did not show any short term capital gains on its return against which to offset that loss. However, the Commissioner, in determining the deficiency, held that there were short term capital gains of $28,260.71 on foreign exchange and allowed the short term capital losses to be deducted in full. His action in this respect is not challenged in this proceeding. The tax is the same whether the $680,587.39

reduces cost of goods sold or is taxed as a short-term capital gain. Thus, it is not necessary to decide in this case whether or not section 117 applies to the futures transactions unless it is held that section 118 also applies. The question of whether transactions in commodity futures are within section 117 is a difficult one as is shown by prior decisions cited by the parties. While there would seem to be logic and common sense in the position which the Commissioner now takes and which the petitioner has always taken in accounting for these transactions, nevertheless, the Court expresses no opinion on that subject at the present time.

Section 118 of the Internal Revenue Code was enacted to prevent a deduction for losses sustained in wash sales of securities; that is, where the taxpayer at or about the time of a sale acquires identical or substantially identical securities. The deduction is postponed until the securities are disposed of and not replaced within 30 days. It provides that no deduction for loss shall be allowed under section 23(f), with exceptions not here material, if the loss is claimed to have been sustained from any sale "of shares of stock or securities" where within 30 days before or after the sale the taxpayer has acquired "substantially identical stock or securities." Other provisions are to the effect that the basis and the holding period of the securities sold attach to the securities purchased where the wash sale provision has applied. The petitioner, by tracing its loss transactions of prior years and assuming that a number of those transactions were wash sales within the meaning of section 118, arrives at bases for the futures sold in 1940 which would show capital gains of $62,328.10 and capital losses of $202,662.60 instead of the gain of $680,587.39 which it reported in accordance with its consistent method of accounting. It relies on *Treaton Cotton Oil Company* v. *Commissioner*, 147 Fed. (2d) 33, rehear-

ing denied, 140 Fed. (2d) 208, reversing on this point a memorandum opinion of this Court.

We are unable to agree with the opinion in the cited case holding that the words "stocks and securities," as used in section 118, include commodity futures and that a new future contract is "substantially identical" with a prior contract. The Appellate Court reasoned that the futures contracts were securities because they were pledged with the broker "who advanced the necessary funds to purchase the oil." Any pledged property is a security in that sense, but obviously not all pledged property is a security within the meaning of section 118. Furthermore, the reasoning is unsound since the broker does not advance the funds necessary to purchase the commodity. The buyer of a commodity futures contract puts up a margin with his broker which is a percentage of the purchase price called for in the contract. That margin is held as security until the contract is closed out. If the purchaser of the contract takes delivery of the corn, he then pays the additional amount called for under the contract, but if he sells the contract he gets credit for the margin which he put up with his broker, plus the price at which the broker sold the contract, and neither he nor the broker makes any further payment on account of the purchase price which that particular purchaser owed under the contract. The Appellate Court also reasoned that the futures contract was "a security" because "the petitioner had no more than a document giving it the right to demand and receive property not in its possession." The owner of a commodity future has no right to demand the property except at maturity upon payment of the contract price. All executory contracts giving a person the right to demand and receive property upon the payment of a contract price are not to be regarded as securities within the meaning of section 118.

Furthermore, a new future commodity contract is not "substantially identical" with any prior contract even though the quantity involved in each is identical. It would be purely accidental if the new contract was with the same party as the one who had agreed to sell the commodity in the earlier contract. The price would probably be different and the delivery date would certainly be different. The United States District Court, Middle District of Georgia, on April 11, 1940, in the case of *Valley Waste Mills* v. *Page*, 27 A.F.T.R. 957, held, in regard to cotton futures, that the new contract was not "substantially identical" with the old one under such circumstances and, with that, we agree. Cf. section 117(d)(3)(B) as added by section 211, Revenue Act of 1950. Cotton futures were considered by the Circuit Court of Appeals for the Fifth Circuit in *Valley Waste Mills* v. *Page*, 115 Fed. (2d) 466; certiorari denied, 312 U.S. 681, and it is apparent from the opinion there that such a future is not a security in any generally recognized sense but simply a contract between two parties in which one agrees to supply at a designated time in the future a stated quantity and quality of goods, upon payment of a stated price and on which a part of the contract price, called a margin, has been paid by the buyer to his broker to bind him until the sale is consummated or the contract is sold. See also *Rosenthal* v. *Brown*, 247 N.Y. 479, 160 N.E. 921. Cf. *Pinellas Ice & Cold Storage Co.* v. *Commissioner*, 287 U.S. 462; *Commissioner* v. *Segall*, 114 Fed. (2d) 706; *Commissioner* v. *Nisto Financial Corporation*, 139 Fed. (2d) 253. Corn futures are not different in this respect from cotton futures. Furthermore, corn futures, such as are here involved, are for such short periods and are of such a peculiar character that they do not lend themselves to the evil which section 118 was intended to prevent. Sales of such contracts are completed transactions when made, the gain or loss is recognized at that time, and there is no postpone-

ment of the gain or loss for tax purposes. *Valley Waste Mills v. Page, supra; Robert M. Harriss*, 44 B.T.A. 999, affirmed, 143 Fed. (2d) 279. Section 118 has no application in this case.

The parties have stipulated that certain adjustments are to be made in computing the tax liability of the petitioner.

Decision will be entered under Rule 50.

CORN PRODUCTS REFINING CO., PETITIONER, v. COMMISSIONER OF INTERNAL REVENUE

Docket No. 22074, June 30, 1952.

Jay O. Kramer, Esq., and Samuel A. McCain, Esq., for the petitioner.

Walt Mandry, Esq., for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

Opper, *Judge:*

Respondent determined deficiencies for the year 1942 in excess profits tax and declared value excess profits tax of $1,520,519.39 and $14,487.94, respectively. Petitioner does not contest certain adjustments. The issues remaining are:

1(a). Whether the profits and losses sustained by petitioner in the years 1939 to 1942, inclusive, on the purchase and sale of corn futures constituted capital gains and losses under section 117, and thus a proper elimination from base period losses for excess profits tax purposes.

1(b). Whether losses sustained by petitioner from transactions in corn futures are subject to the wash sales provisions of section 118.

1(c). If the answer to 1(a) is in the negative, whether the net loss on corn futures transactions sustained by petitioner in the base period year 1939 constituted an abnormal deduction under section 711(b)(1)(J)(ii).

2. Whether dividends declared by foreign corporations payable to petitioner in foreign currency in the base period year 1939 were so blocked by foreign exchange restrictions as not to constitute taxable income in that year.

3. Whether sums paid out as "salaries" and included as part of cost of sales are deductible, although in a later year it was discovered that the amounts had been embezzled and reimbursement from insurance was subsequently received.

4. Whether, in computing petitioner's unused excess profits credit carry-over from 1941 to 1942, the provisions of section 721 apply so as to exclude 1941 abnormal income from excess profits net income of that year, even though petitioner had no excess profits tax liability for 1941.

Some of the facts have been stipulated. The record in Corn Products Refining Co., 16 T. C. 395, has been incorporated by agreement as evidence in this proceeding.

Findings of Fact.

The stipulated facts in this proceeding, and the findings of fact in Corn Products Refining Co., 16 T. C. 395, are hereby found accordingly.

Petitioner is a New Jersey corporation with its prin-

cipal office in New York City. It filed its 1942 return with the collector of internal revenue for the second district of New York.

Issue 1

Petitioner is engaged in the manufacture and sale of corn products, including starches, sugar, syrups, oils and feeds. The principal product obtained by petitioner from raw corn is starch. Cerelose, which is one of petitioner's major products, is a refined sugar derived from starch which competes with cane and beet sugar. Petitioner's plants have a daily grind capacity of 170,000 bushels, and its raw corn storage capacity of 2,303,000 bushels enables it to keep on hand somewhat less than a three-weeks' supply. In the years 1938 to 1942, inclusive, petitioner made purchases of raw corn aggregating 35,650,773, 36,806,869, 37,222,409, 54,079,173, and 60,761,513 bushels, respectively.

Petitioner's sales policy has been to contract for shipments within 30 days at a specified tentative price, with the understanding that the final price shall be the contract price or market price at date of delivery, whichever is lower. When a customer refuses to accept delivery of cerelose or feed, it has been petitioner's practice to cancel the unexecuted portion of the order.

Petitioner's general sales policy of contracting for 30-day shipments has had exceptions and variations, including the following: In 1927, petitioner entered into a contract with the Huron Milling Company, and in 1932 it entered into a contract with the Keever Starch Company, under both of which contracts petitioner was required to manufacture and deliver large quantities of starch for a period of 15 years, the price in both contracts being dependent upon a number of factors, including the price of corn and labor. The Huron contract was modi-

fied on June 1, 1942, and extended for an additional 10 years. In May 1939 petitioner entered into a contract with Eastern Milling Co. under which petitioner was required to deliver quantities of feed each month until May 1940, with a guarantee as to price. On January 15, 1940, petitioner invited all buyers to submit on or prior to January 20, orders for cerelose to be delivered as late as June 30, 1940, buyers being guaranteed the lower of the January 15 price or the price in effect at date of delivery, and being allowed to cancel all or part of their orders. Petitioner received many orders in response to that invitation and its sales of cerelose at that time approximated 2,000,000 bags. Members of the canning industry on the Pacific Coast have been permitted to call on petitioner for cerelose for delivery in more than 30 days, with price guarantees and allowance for cancellations.

For a number of years it has been petitioner's custom to purchase and sell corn futures contracts through members of a recognized Commodity Exchange. A corn future is a contract calling for the delivery at a stated time, within eleven months or less, of 5,000 bushels of corn or some multiple thereof, of a stated quality, at a stated price. Petitioner engaged in futures transactions as a part of its corn buying program and as the most economical method of obtaining an adequate supply of raw corn in view of its limited storage facilities and the expense of increasing those facilities sufficiently to take care of its needs. Purchases of futures were made when the price of corn was advantageously low. Petitioner took delivery of corn on some contracts, but it usually sold most of its futures in early summer if it then appeared that there would be no shortage of corn and no great danger of increased prices. If the crop was poor or there was danger of a price increase it sold its futures gradually as it bought corn for grinding. Petitioner

would begin to acquire additional futures contracts at harvest time each year.

The corn futures contracts were not subject to depreciation and were not included in inventory. Petitioner's raw corn inventory account was affected only when petitioner took delivery under a futures contract. Profits or losses on futures were shown in a "Corn Miscellaneous" account. The net gain or loss for each year was debited or credited to cost of sales, and treated as a reduction or addition to cost of goods sold.

During late 1939 and early 1940 petitioner maintained a long position in corn futures contracts of from 7,000,000 to 8,000,000 bushels. In 1940 the Commodity Exchange Authority formally charged petitioner with speculating in grain on the ground that it had a long position in excess by more than 2,000,000 bushels of the amount it required for hedging. At a hearing petitioner took the position that its futures were not in excess of its needs and that the contracts it held were necessary to cover the products which it expected to market over a period of 15 to 18 months. In demonstrating its needs petitioner submitted evidence as to its unfilled orders, its sales commitments, its contracts with the Huron Milling Company and the Keever Starch Company, and the estimated number of bushels of corn that would be required to meet such commitments. Petitioner relied also upon weekly and daily reports which it had filed with the Authority giving information as to its position with respect to grain futures. Petitioner had included in those reports, among other matters, detailed information as to its transactions in grain, and its purchase and sales commitments for grain, or grain products, and it stated in such reports that its futures were classifiable in character as hedging, rather than as speculative transactions. Petitioner was upheld in its contentions in the proceeding before the

Commodity Exchange Authority, and the action was dismissed.

The parties have stipulated the net gain or loss from the purchase and sale of corn futures in each year from 1932 to 1942, inclusive, the monthly purchases of bushels of raw corn by petitioner from January 1938, to December 1942, the monthly purchases and sales of corn futures during the same period including the number of contracts and number of bushels, the monthly purchases of corn futures from October 1937 to December 1942 under which delivery was taken at maturity dates, the monthly sales of corn futures from January 1938 through December 1942, including the number of contracts and number of bushels, and the stock on hand and unfilled orders for cerelose and for feed at the beginning of each month during the year 1942.

The parties have stipulated for each of the years 1939 and 1942 the separate gain or loss to petitioner resulting from the sale of corn futures held for not more than six months and from the sale of corn futures held for more than six months, as computed both with and without the application of section 118 of the Internal Revenue Code.

During 1942 petitioner had gross sales of more than $131,000,000 and gross profits from sales of more than $35,000,000. Its net loss from the purchase and sale of corn futures was $109,969.38. At the beginning and end of that year its inventory (including raw corn and processed products valued at cost or market, whichever was lower) was approximately $7,650,000 and $5,900,000, respectively.

There was no significant change in petitioner's method of doing business between December 31, 1940, and December 31, 1942.

Petitioner's purchases of corn futures did not constitute speculative transactions for profit, but were consummated

in order to obtain business protection and to insure the profitable conduct of its business.

Issue 2

During all periods material to this proceeding the books and records of petitioner and its subsidiaries were kept on an accrual basis.

During 1939 Maizena, Brazil, S. A., a Brazilian corporation, hereinafter called Maizena, and Refinacoes De Milho, Brazil, S. A., a New Jersey corporation, hereinafter called Refinacoes, were petitioner's wholly-owned subsidiaries. In that year Refinacoes owed Maizena money for commissions. On the books of Maizena the commissions were credited to profit and loss, and debited to its accounts receivable account for Refinacoes. Maizena paid taxes to Brazil upon the commissions.

In December 1938 Maizena declared a dividend, payable January 13, 1939, and set up on its books an account payable to petitioner in the amount of 2,175,000 Brazilian milreis. In June 1939 petitioner debited an accounts receivable account known as blocked account, Maizena, Brazil, S. A., and it credited blocked income which was a deferred credit income account. Petitioner used a rate of exchange of 5.95 cents per milrei. The Internal Revenue Bulletin stated that the rates of exchange acceptable as the prevailing current or market rates were 5.86 per milrei as of December 30, 1938, and 6.058 cents per milrei as of December 30, 1939. There was also an unofficial rate of exchange in Brazil.

Petitioner was interested at that time in selling milreis for dollars to foreign exchange dealers in New York, if favorable rates were obtainable. There were restrictions in Brazil in 1939 with respect to transmitting funds out of that country. The record does not disclose the nature or extent of such restrictions.

Appendix B

In 1939 petitioner received a portion of the above dividend in the amount of $4,862.31, which was the dollar equivalent of 100,649.9 milreis. That payment was made by draft, payable in petitioner's favor, and drawn by the Bank of Brazil upon the Guaranty Trust Co. The record does not disclose the circumstances under which such drafts were procured. Petitioner received the balance of the dividend in 1940. Upon receiving payment petitioner debited its cash and blocked income accounts, and credited income and its blocked account, Maizena, Brazil, S. A.

During 1939 petitioner was a major stockholder in several Italian companies, including S. A. Anficromos Dott Aldo Volpino-Milan, hereinafter called Anticromos, S. A. Ligure Industriale Commerciale-Genoa, hereinafter called Ligure, S. A. Prodotti del Mais-Milan, hereinafter called Prodotti, and Fabbriche Riunite Amido Glucosia Destrina-Milan, hereinafter called Fabbriche. Petitioner had wholly-owned Italian subsidiaries, including Societe Finanziaria Agricola Italo-Americana-Milan, hereinafter called Finanziaria.

In May 1939 dividends in lire were declared by the above corporations and set up on their books as accounts payable to petitioner, as follows: Anticromos—142,920; Ligure—565,763; Prodotti—1,643,718; and Fabbriche—2,143,926 lire. In that year petitioner entered the above amounts on its books by debiting its accounts receivable maintained for the above corporations which were called blocked accounts; and by crediting its blocked income account, which was a deferred credit to income. Petitioner used a rate of 5.2625 cents per lire which was the published rate of exchange on the date of declaration of dividends.

The dividends declared by Anticromos and Ligure were paid in the same year to petitioner's subsidiary, Finanziaria. Finanziaria credited petitioner's account and ac-

crued interest which was also credited. An undisclosed portion of the dividends received by Finanziaria and an undisclosed portion of the dividends declared by Prodotti and Fabbriche were transferred on undisclosed dates to Italian banks for petitioner's credit. The record does not disclose when the Italian dividends which were declared in 1939 payable to petitioner were received by the latter.

Petitioner was anxious at a reasonable price to realize dollars for its lire, and it was able in New York to sell to foreign exchange dealers some of the lire in its bank accounts at unofficial rates. In November and December 1939 petitioner converted the sums of 210,000 and 200,000 lire into dollars at an average rate of approximately $.021 per lira. The latter lire would come out of dividends declared in 1936, if treated on a first in, first out basis. The record does not disclose the nature or extent of the exchange restrictions in Italy on transmitting funds out of that country.

Petitioner's consistent bookkeeping practice, in treating a foreign dividend payable to it and blocked by exchange restrictions, has been to record the dividend as a receivable at the prevailing rate of exchange with a credit to deferred income, and to treat the amount as income in the year of actual receipt in the United States. Petitioner has adhered to that procedure following an internal revenue agent's suggestions in connection with examinations of its returns for certain years prior to the period here involved.

Petitioner's 1939 tax return reported as income the portion of the Maizena dividend received in that year. It did not report the remainder of the Maizena dividend or the dividends declared in that year by the Italian corporations. That method of reporting was in accordance with petitioner's practice, in 1939 and subsequent years, of reporting items of foreign income, blocked by exchange

restrictions, at the time of actual receipt, and treating them as capital gain items with a cost basis of zero.

The dividends in controversy were not unqualifiedly subject to petitioner's demand in the year 1939. In 1939 there was no market for the unconverted Brazilian milreis and the Italian lire here in controversy, and no one could form an opinion as to their values in that year.

Issue 3

During 1942 petitioner paid out as "salaries" the gross sum of $37,620.44. The net amounts so paid were in fact embezzled by the paymaster and were not received by the employees designated on the checks as payees. The total sum of $37,620.44 was deducted in good faith as part of cost of sales. In addition, based upon the above "salaries," petitioner withheld and paid to the Treasury, as the employer's portion of Federal Old Age Benefit, the amount of $357.39, and as Federal Unemployment Insurance the amount of $676.55. The latter sums were deducted in good faith.

In 1948 petitioner discovered the embezzlements and made a claim for reimbursement from its surety under its policy of insurance which was in effect at all times. In 1949, under the terms of its policy, petitioner received from the surety reimbursement of the above sum of $37,620.44, without interest.

Respondent's notice of deficiency, mailed on December 14, 1948, did not disallow any of the above sums. At the hearing, respondent claimed an additional deficiency based upon the disallowance of the amount of $37,620.44 as a deduction for 1942.

Issue 4

Petitioner had no excess profits tax liability for 1941, and in so determining, respondent excluded from peti-

tioner's excess profits net income for that year the sum of $436,945.36 as abnormal income under section 721 of the Internal Revenue Code. Respondent's computation of petitioner's unused excess profits tax credit carry-over from 1941 to 1942 did not exclude from petitioner's excess profits net income for 1941 the said amount of $436,945.36.

OPINION

I.

Issue 1(a).

Although perhaps not conforming technically to the definition of a hedge,[1] it seems indisputable as our findings show that petitioner's practice of purchasing corn futures was an integral part of its manufacturing business. *Ben Grote*, 41 B.T.A. 247; see *Kenneth S. Battelle*, 47 B.T.A. 117, 127. It would hence be anomalous to view them as purely speculative transactions of a capital nature,[2] especially considering that this is "largely a factual question," *Kenneth S. Battelle*, *supra*, 125, and the burden here is on petitioner to show that it incorrectly treated the losses as ordinary on its original tax returns. Only by so doing can it succeed in maintaining its present position that losses in the base period were improperly

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1 "* * * to hedge, i.e., to insure themselves against loss by unfavorable changes in price at the time of actual delivery of what they have to sell or buy in their business; * * *." *United States v. New York Coffee & Sugar Exchange, Inc.*, 263 U. S. 611. See Patterson, "Hedging and Wagering on Produce Exchanges," (1931), 40 Yale L. J., 843, 846.

2 "* * * For example, if a manufacturer or processor of raw materials is short on inventory and make sales of his finished products for forward delivery, the appropriate hedging transaction in that instance would be the purchase of raw material futures at or about the time he makes the sale." *Stewart Silk Corp.*, 9 T. C. 174, 178.

employed to arrive at a smaller income than actually received.

Futures contracts need not be concurrent with spot transactions in order to be a hedge. G. C. M. 17322 (1936), XV-2, C. B., 151. In neither *Tennessee Egg Co.*, 47 B.T.A. 558, nor *Estate of Dorothy Makransky*, 5 T. C. 397, affirmed (C. A. 3), 154 Fed. (2d) 59, were there future commitments against which the futures purchased could operate as an offset. In the former, petitioner's failure to sustain its burden of proof is emphasized, and in the latter the venture in question was an isolated transaction and not a component of a regular practice of balancing transactions systematically conducted. Neither case is authority militating against our conclusion that petitioner's losses on its futures contracts were properly treated as ordinary losses. *Stewart Silk Corp.*, 9 T. C. 174, 179.

II.

Issue 1(b)

Petitioner's alternative contention that Internal Revenue Code, section 118, forbade deduction of these losses as wash sales must be rejected on authority of *Corn Products Refining Co.*, 16 T. C. 395, a prior decision involving this same petitioner from which we see no reason to depart.

III.

Issue 1(c)

That the futures contracts gave rise to a separate class of losses, however, we think admits of little doubt. Al-

though related to petitioner's cost of operations, they cannot be considered an inventory item, *Modesto Dry Yard, Inc.*, 14 T. C. 374, nor, since the grain itself was never acquired, a part of the costs of goods sold. See *Tennessee Egg Co., supra; Estate of Dorothy Makransky, supra; Modesto Dry Yard, Inc., supra.* Being losses on transactions comparable to hedges, they are strictly similar only to other hedge transactions. We conclude that, being greater than 125 per cent of previous items of the same character, the losses are subject to treatment under section 711(b)(1)(J)(ii). *Green Bay Lumber Co.*, 3 T. C. 824; *Welch Grape Juice Co.*, 9 T. C. 786; *Mine and Smelter Supply Co.*, 10 T. C. 1179.

For the first time on brief, respondent seeks to invoke the provisions of section 711 (b)(1)(K). Assuming that the ordinary burden of disclosure rested upon petitioner in that state of the record, but see *Green Bay Lumber Co., supra; Wentworth Manufacturing Co.*, 6 T. C. 1201, it has in our view been adequately met. There is no apparent causal connection between the losses on futures and the gross income or deductions of petitioner's operations. And the abnormal losses do not seem to have been a consequence of a change in the manner and scope of petitioner's operations. *R. C. Harvey Co.*, 5 T. C. 431; *Laredo Bridge Co.*, 7 T. C. 17.

If there are more obscure connections between the contested losses and any of the enumerated aspects of petitioner's activities as described in section 711(b)(1)(K), it was incumbent on respondent to give some adequate notice of his proposed position. A taxpayer cannot be expected to negative every possible element of some hypothetical defense. *Wentworth Manufacturing Co., supra.*

In this respect respondent's determination was erroneous.

Appendix B

IV.

Issue 2

On petitioner's claim that it understated its 1939 income by failing to report dividends received in Brazil and Italy, we conclude that the burden of proof which rested on petitioner has not been discharged. It is not sufficient for the dividends to have been received in foreign territory. They must have been convertible into American dollars before petitioner could be charged with them as income. *Foundation Co.*, 14 T. C. 1333. This was one of the issues in the case and proof of convertibility was requisite under the circumstances. *International Mortgage & Investment Corp.*, 36 B.T.A. 187. In *Weil* v. *Commissioner* (C. A. 2), 150 Fed. (2d) 950, the taxpayer had the burden of proving the absence of free convertibility, rather than as here, its presence, and failed to carry it. Petitioner's failure to sustain its burden in this respect is the basis for our conclusion contained in the findings that there was no market for the foreign exchange in dispute.

In fact, what evidence there is indicates that these payments were actually blocked by the respective exchange restrictions of the countries involved. The facts show that except for a small portion actually converted in some manner not disclosed, and not here in controversy, the entire amount was credited to deferred income. This was stated to be petitioner's method of dealing with blocked funds: "If the foreign dividend payable to us was blocked by exchange restrictions our practice was to book the dividend as a receivable at the prevailing rate of exchange, offset by a credit to the deferred income, taking it into income in the year it was received." When the dividends were "received," that is, when they were exchanged into dollars and transferred to the United States—all of which

occurred subsequent to the year in issue—and not until then were they recorded as income. On this issue the deficiency is sustained.

V.

Issue 3

We do not view the issue affirmatively raised by respondent as one directly involving the deductibility of an embezzlement loss. At the close of the taxable year in question, 1942, from all that was then known, petitioner correctly deducted the amounts in issue as compensation for services. The fact that six years later it was discovered that these items had never been paid to the employees but had been misappropriated and that a year after that petitioner was able to collect from its insurer would, as in *E. B. Elliott Co.*, 45 B.T.A. 82, be pertinent facts for consideration if the year 1942 could be dealt with in reliance upon them. But as we have frequently reiterated, the *Elliott* rule no longer applies. *Standard-Tilton Milling Co.*, 3 T. C. 1026; *Taylor Instrument Companies*, 14 T. C. 388.

Only by reviewing the year in controversy in the light of facts discovered many years later can petitioner's position be attacked. This as we have said we are no longer in a position to do. *Schwabacher Hardware Co.*, 45 B.T.A. 699, was decided after *E. B. Elliott Co., supra*, and on its authority, and before *Standard-Tilton Milling Co., supra*. For that reason it has no application to these proceedings. And in *Samuel M. Felton*, 5 T. C. 256, the burden was not upon respondent, as it is here, but upon petitioner. Under the *Security Flour Mills*[3] rule, respondent has not even closely approximated the discharge

[3] *Security Flour Mills* v. *Commissioner*, 321 U. S. 281.

of the burden which he is required to bear. On this issue, decision will be for petitioner.

Issue 4

The final question is controlled by *San Francisco Stevedoring Co.*, 8 T. C. 222, as petitioner concedes. It attacks the conclusion there reached and urges us to depart from it. This we are unwilling to do. On the authority of that case, the deficiency is sustained in this respect.

Decision will be entered under Rule 50.

CORN PRODUCTS REFINING CO., PETITIONER, v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

(U. S. Court of Appeals, Second Circuit, Nos. 158, 159, Aug. 25, 1954)

Before: Chase, *Chief Judge*, Hincks and Harlan, *Circuit Judges.*

Consolidated petitions to review decisions of the Tax Court redetermining a deficiency in the income taxes of the petitioner for 1940 and deficiencies in its excess profits taxes and declared value excess profits taxes for 1942. Affirmed.

Jay O. Kramer, Samuel A. McCain, Attorneys for Petitioner.

H. Brian Holland, Assistant Attorney General, Ellis N. Slack, Lee A. Jackson, Harry Marselli, Special Assistants to the Attorney General, for Respondent.

Appendix B

Chase, *Circuit Judge*:

The petitioner, a New Jersey corporation which has its principal office in the City of New York, is engaged in manufacturing and selling corn products, including sugars, starches, oils and feeds. The Commissioner determined a deficiency of $163,804.78 in its income tax for 1940; a deficiency of $1,520,519.39 in its excess profits tax for 1942; and a deficiency of $14,487.94 in its declared value excess profits tax for that year. The Tax Court upheld the Commissioner and petitions to review its decisions have been consolidated for hearing in this court. The opinion of the Tax Court and its findings of fact as to the issues for 1940 are reported at 16 T. C. 395 and familiarity with them will be assumed. Reference is also made to the unreported opinion and findings of fact of the Tax Court, as to the issues for 1942, in Tax Court Docket No. 22,074.

Four questions are presented as to the tax liability of the petitioner for the years 1940 and 1942. Involving both 1940 and 1942 are questions of the taxability of profits and losses in the purchase and sale of corn futures as ordinary income and loss or as capital gain and loss under Section 117(a) of the Internal Revenue Code, 26 U. S. C. A. § 117(a), and the applicability of Section 118 of the Code, 26 U. S. C. A. § 118, to those transactions. Involving only the tax year 1942, are two questions related to the petitioner's excess profits credit and carry-over.

In its business the petitioner uses large amounts of corn, often as much as 170,000 bushels per day. The maximum amount of raw corn which it could store during the relevant periods was roughly 2,300,000 bushels, only about three weeks supply, so it decided to deal in corn futures in order to insure a stable price for the raw product by thus eliminating price fluctuations caused by occasional supply shortages on the market. The method adopted was to purchase corn futures through a commodity ex-

change whenever the price of corn was satisfactorily low and hold them until it could be ascertained whether there would be a crop shortage. Then the futures would be in part liquidated if, and when, need for retaining them ceased because of the condition of the anticipated crop. The method was followed each season.

The petitioner had future sales commitments, but these were mainly of an unfixed character in that the purchaser was given the benefit of the lower of the order price or the delivery date market price. So, with long purchases of futures set against future sales at the order or market price, whichever was lower, the respondent protected itself against commodity price rises but not against declines.

In the years 1940 and 1942 the petitioner's purchases and sales of corn futures resulted respectively in a gain of $680,587.39 and a loss of $109,969.38 and in its tax returns for those years these were treated as items of ordinary income and loss, being entered in petitioner's books as an increase and decrease in cost of goods sold. However, from 1940 to 1946 the Commissioner successfully contended in a series of instances[1] that dealings in commodity futures contracts gave rise to capital, rather than ordinary, gains and losses and in reliance on those cases the petitioner sought to have them treated as capital in nature under Section 117(a) of the Code.

In addition to seeking capital treatment on these items the petitioner also contended that many of the past futures transactions came within the "wash sales" provision of Section 118 which would do away with loss deduction under Section 23(f) and transfer the basis of the "washed" security to the purchased security and, in this case, increase the basis of those futures sold in 1940 and 1942.

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[1] *George W. Covington*, 42 B. T. A. 601; aff'd 5 Cir., 120 F. 2d 768, cert. denied 315 U. S. 822; *Tennessee Egg Co.*, 47 B. T. A. 588; *Trenton Cotton Oil Co.* v. *Commissioner*, 6 Cir., 147 F. 2d 33; *Farmers & Ginners Cotton Oil Co.* v. *Commissioner*, 5 Cir., 120 F. 2d 772, reversing 41 B. T. A. 1083; *Makransky, Estate of Dorothy, Deceased, et al.*, 5 T. C. 397, aff'd 3 Cir., 154 F. 2d 59.

The Tax Court held that these commodity transactions gave rise to ordinary income and loss since the petitioner's system of purchasing corn futures "was an integral part of its manufacturing business." It is the position of the petitioner to the contrary that, within the meaning of Section 117(a), commodity futures contracts are "property held by the taxpayer" and do not come within the types of property excluded from the section, not being stock in trade, inventory, property held primarily for sale to customers, or the like, and therefore capital in nature.

In addition to those exclusions specifically provided for in Section 117 the petitioner contends that the courts have set up a "judge-made exception"; that is, that gain and loss from commodity futures transactions will not be given capital treatment when they have been utilized for the commercial purpose known as "hedging." And, even assuming that this "judge-made exception" is proper, it would not be applicable here because the petitioner, so it claims, was not hedging. We think the petitioner has misconstrued the effect both of the cases and of its own dealings.

Hedging is a method of dealing in commodity futures whereby a person or business protects itself against price fluctuations at the time of delivery of the product which it sells or buys. *United States* v. *New York Coffee & Sugar Exchange*, 263 U. S. 611. A typical example of hedging occurs when a manufacturer of grain products seeks to stabilize its costs against fixed forward sales prices. Having contracts for the delivery of its grain products to its customers at fixed prices, the manufacturer seeks to set the cost of its related inventory item, grain, by entering into futures contracts for the purchase of it. By so doing the manufacturer may later obtain the necessary grain at a price properly related to the already fixed selling price of his manufactured product and, so far as commodity

costs are concerned, the profit from manufacturing is insured.

In *United States* v. *New York Coffee & Sugar Exchange, supra,* the Supreme Court set forth three general classifications of dealings in commodity futures: speculation, legitimate capital transactions, and hedging. These classifications have since been adopted as convenient nominal guides by the courts to determine the proper tax consequences of futures transactions.[2] Where futures are dealt with for the purposes of speculation or what is called legitimate capital transactions, they obviously fall outside the possibly relevant exclusions of Section 117(a). In the hedge, however, the property is used in such a manner as to come within the exclusions, for it is a part of the inventory purchase system which is utilized solely for the purpose of stabilizing inventory cost. It is an integral part of the productive process in which the property is held not for investment but for the protection of profit with the intent of disposition when that purpose has been achieved. As such it cannot reasonably be separated from the inventory items and the cost (or profit) from such operations would necessarily be entered in the books of account of the business as part of cost of goods sold. The tax treatment of hedges, then, is not a "judge-made exception" to Section 117(a); it is simply a recognition by the courts that property used in hedging transactions properly comes within the exclusions of the section.

The futures transactions of this petitioner, it is true, did not constitute what is known as "true" hedging. The true hedge can occur only when forward sales prices are fixed and the relation between commodity purchase and later sales price is insured against both increase and decrease of commodity prices. As the forward sales prices here were based mainly on the lower of order or market prices, the petitioner was protected only against increases

[2] See cases cited in footnote 1.

in commodity prices and did not have the complete insurance of the true hedge. But this is a distinction presently of no significance. The property here was used for essentially the same purpose and in the same manner as in true hedging. Futures contracts were entered into to stabilize inventory costs and thus protect profit, and whether complete or only partial insurance was thereby obtained is simply a difference in degree, not in kind. Therefore, for the same reasons that the true hedge is not accorded capital treatment under Section 117(a), the kind of transactions with which we are now concerned are not to be regarded as capital ones either.

The petitioner's further contention that the wash sales provision of Section 118 is applicable to its futures transactions rests on *Trenton Cotton Oil Company* v. *Commissioner*, 6 Cir., 147 F. (2d) 33, rehearing denied 148 F. (2d) 208. With deference, however, we find ourselves unable to agree with that decision. Cf. *Harriss* v. *Commissioner*, 2 Cir., 143 F. (2d) 279; *Valley Waste Mills*, 5 Cir., 115 F. (2d) 466, cert. denied 312 U. S. 681.

Disallowance of loss deduction under Section 118 occurs only on the sale and purchase of "shares of stock or securities," and only if the stocks or securities purchased are "substantially identical" with those sold. The transactions here are distinguishable on both grounds, for reasons well stated in the opinion below. On the question of substantial identity the Tax Court said: "Furthermore, a new future commodity contract is not 'substantially identical' with any prior contract even though the quantity involved in each is identical. It would be purely accidental if the new contract was with the same party as the one who had agreed to sell the commodity in the earlier contract. The price would probably be different and the delivery date would certainly be different." And on the question of whether commodity futures contracts are securities: "it is apparent from the opinion (*Valley Waste*

Mills v. *Page*, 115 F. (2d) 466, cert. denied, 312 U. S. 681) that such a future is not a security in any generally recognized sense but simply a contract between two parties in which one agrees to supply at a designated time in the future a stated quantity and quality of goods, upon payment of a stated price and on which a part of the contract price, called a margin, has been paid by the buyer to his broker to bind him until the sale is consummated or the contract is sold * * *" We are in accord and take the above as the correct analysis and disposition of this point.

The third point raised by the petitioner is that the Tax Court erred in not holding that dividends declared by certain foreign corporations and payable to petitioner in 1939 were includible in its income for 1939. The effect of the inclusion of those amounts in 1939 income would be to increase petitioner's excess profits credit and its unused excess profits carry over to the year 1942, and thereby reduce the 1942 excess profits tax.

In 1938 a Brazilian corporation, wholly owned by petitioner, declared a dividend of 2,175,000 Brazilian milreis, payable in 1939. In 1939 four Italian corporations in which the petitioner was a major stockholder declared and made payable to petitioner dividends totalling 4,496,327 lire. These dividends were, however, payable only in blocked currency. Consistent with its practice of treating blocked foreign dividends as income only when actually received in the United States in dollars, the petitioner entered these dividends on its books of account as deferred income and did not report them as income in 1939 for tax purposes.

In order to prove that the foreign dividends should have been included in 1939 income, it was necessary to show that instead of being blocked the dividends were in fact freely convertible into dollars. The petitioner offered as such proof the fact that in 1939 it had converted 100,

649.9 milreis and 410,000 lire into dollars. There was no showing of the manner of conversion. The Tax Court held that this evidence was not sufficient to discharge the petitioner's burden of proof and accordingly held that the foreign dividends were not includible in 1939 income.

The petitioner insists that the Tax Court erred both in putting the burden of proof on the petitioner and in not holding its evidence of conversion of some milreis and lire into dollars to be sufficient proof of free convertibility. As to the burden of proof it is so well settled as not to need much comment that in proceedings before the Tax Court the petitioner must *affirmatively* establish its case. *Edward T. Weil, Inc.* v. *Commissioner*, 2 Cir., 150 F. (2d) 950, on which the petitioner relies for the proposition is not in conflict with the general rule but recognizes expressly that, "The burden was upon the taxpayer to establish that the assessment of gain could not be made upon the basis of current exchange."

Rule 32 of the Rules of Practice before the Tax Court, 26 U. S. C. A. § 1111, provides: "The burden of proof shall be upon the petitioner, except as otherwise provided by statute, and except that in respect of any new matter pleaded in his answer, it shall be upon the respondent." The issue of convertibility is not the subject of other legislation shifting the normal burden and here the issue was not new matter pleaded in the respondent's answer. Accordingly, the exceptions are inapplicable and the burden of proof was properly placed on the petitioner.

The evidence amply supports the Tax Court's conclusion that the petitioner failed to prove free convertibility. Only small portions of the dividends were converted into dollars, and the manner of conversion was not even shown. The entire remainder of the dividends was treated as deferred income. Such a showing, far from being adequate proof of free convertibility, tended to suggest the lack of it.

Appendix B

The final point raised by the petitioner is concerned with a determination with respect to abnormal income under Section 721 of the Code. But Section 732(c), which provides that any determinations made solely by reason of Section 721 of the Code are final and "shall not be reviewed or redetermined by any court * * *" deprives us of jurisdiction to review this determination. *George Kemp Real Estate Co.* v. *Commissioner*, 2 Cir., 182 F. 847, cert. denied 340 U. S. 852; *James F. Waters, Inc.* v. *Commissioner*, 9 Cir., 160 F. (2d) 596, cert. denied 332 U. S. 767.

Decision affirmed except as to the final point and as to that the petition is dismissed for lack of jurisdiction.

APPENDIX C

ESTATE OF DOROTHY MAKRANSKY, DECEASED, *et al.*, PETITIONERS, v. COMMISSIONER OF INTERNAL REVENUE

(U. S. Circuit Court of Appeals, Third Circuit, Nos. 9076-9080, February 25, 1946)

On petitions for review of Decisions of the Tax Court of the United States.

Before Maris, Goodrich and O'Connell, Circuit Judges.

OPINION OF THE COURT

Per Curiam:

In these cases the taxpayers ask this court to review the finding of the Tax Court that a loss which they incurred in the sale of contracts for the future delivery of wool was a loss upon the sale of capital assets and not an ordinary and necessary expense of their business deductible under Section 23(a) of the Internal Revenue Code or a loss deductible under Section 23(e). We think that this is a finding which this court is not at liberty to review. *Dobson* v. *Commissioner*, 320 U. S. 489 (1943); *Kelley Co.* v. *Commissioner*, — U. S. — (1946).

The decision of the Tax Court is affirmed.

ESTATE OF DOROTHY MAKRANSKY, DECEASED, *et al.*, PETITIONERS, v. COMMISSIONER OF INTERNAL REVENUE

Docket Nos. 3353, 3354, 3355, 3356, 3357.

Promulgated July 12, 1945.

Petitioners were the members of a partnership engaged in the business of manufacturing men's suits from piece material. At the outbreak of the present war all lines of piece goods were withdrawn from the market. At that

time the partnership had on hand only a six-month supply of piece goods. During September 1939 it purchased on margin through a broker certain futures contracts calling for delivery of wool tops in March 1940. At the time these contracts were purchased the partnership intended to take delivery of the wool tops and have them converted into piece material. Towards the close of 1939 piece goods were again offered on the market and the partnership learned that the wool tops to be delivered in March were of an inferior grade and could not be used in its business. During February 1940 it sold the futures contracts at a substantial loss. *Held*, the loss thus sustained by the partnership was a "short-term capital loss" as that term is defined in section 117(a) of the Internal Revenue Code and was not a business expense deductible from gross income under section 23(a)(1)(A); *held, further*, the partners are not entitled under sections 23(s), 122, and 189 to deduct from their gross incomes for the taxable year 1941 any "net operating loss carry-over" on account of the loss sustained by the partnership on its wool tops futures contracts.

Samuel H. Levy, Esq., for the petitioners. W. J. McFarland, Esq., for the respondent.

These proceedings, duly consolidated, involve deficiencies in income tax for the calendar year 1941 determined by the respondent against petitioners in the amounts of $3,961.82, $4,403.37, $4,166.11, $3,720.08, and $4,169, respectively.

The deficiencies result from the respondent's determination that each petitioner should be taxed with "Income from partnership" of $17,564.54 ($17,564.53 in Docket Nos. 3354 and 3356) not reported on their individual returns. This adjustment was identically explained in each deficiency notice as follows:

Your distributive share of income from the S. Mak-

ransky & Sons partnership has been adjusted to reflect the disallowance of an alleged 1940 operating loss carried over and claimed as a deduction by the partnership in its return for 1941.

By appropriate assignments of error each petitioner contests this adjustment.

The respondent also allowed each petitioner, except Edward Makransky in Docket No. 3354, additional deductions for contributions, but these adjustments are not in controversy.

Findings of Fact.

Many of the facts have been stipulated. The stipulation and the exhibits thereto are incorporated herein by reference.

Petitioners in Docket No. 3353 are the executors of the will of Dorothy Makransky, who died on December 31, 1943. The original petitioner in Docket No. 3353 was Dorothy Makransky, an individual, residing in Philadelphia, Pennsylvania. She filed her income tax return for the calendar year 1941 with the Collector for the First District of Pennsylvania.

Petitioners in the remaining dockets are individuals and residents of Philadelphia, Pennsylvania. They too filed their income tax returns for the calendar year 1941 with the collector for the first district of Pennsylvania. At all times material herein Dorothy Makransky and the petitioners in the remaining dockets composed the partnership of S. Makransky & Sons, hereinafter sometimes referred to as the partnership. The partnership filed returns for the calendar years 1940 and 1941 with the collector for the first district of Pennsylvania.

The partnership is the successor to the clothing business of S. Makransky & Sons, Inc., a Pennsylvania corpora-

tion. Since prior to 1918 the partnership and its predecessor concerns have been engaged in the City of Philadelphia, Pennsylvania, in the manufacture and sale to retailers of men's ready-to-wear suits. The finished stock of the partnership is sold by retailers under the partnership's trade name of "Devonshire Clothes" or under the name of the retailer.

The partnership obtains piece goods from weavers of woolen or worsted cloth, which are sponged by an independent contractor in order to pre-shrink the cloth and are then manufactured by the partnership into the finished clothing. Orders for the purchase of piece goods by the partnership for the spring and summer line are placed with the weavers principally during the preceding July and August, and deliveries are made to the partnership by the weavers commencing in December and extending through the subsequent months of January, February, and March. Orders for the purchase of piece goods by the partnership for the fall and winter line are placed with the weavers principally during January and February and deliveries are made by the weavers to the partnership commencing in June and extending through the next succeeding three months of July, August, and September.

The partnership employs numerous salesmen to sell its finished product to retailers throughout the United States. In this connection, sample suits and swatches of its prospective spring and summer line are made up by the partnership and furnished its salesmen during September and October. Its salesmen contact prospective purchasers during the fall season for the purpose of obtaining orders for the sale of the finished stocks of the partnership for the following spring and summer. Actual manufacture by the partnership in accordance with the sales orders obtained by its salesmen is conducted by the partnership over the period from about November through the sub-

sequent month of April and sometimes May. As to the fall and winter line, sample suits and swatches are furnished to the salesmen during the preceding March and April. Sales orders are taken by the salesmen during April and May from prospective purchasers and the actual manufacture of its finished stock with which to fill the sales orders is conducted by the partnership during the period of June through October and sometimes November.

All orders for its finished product were accepted by the partnership subject to the following conditions fully set forth in the orders:

"We are not responsible for the late or nondelivery of all or any part of this order due to fire, strikes, inability to procure piece goods or due to government orders or any other reason; nor does the delivery of any part of this order obligate us to deliver any other part hereof. We may discontinue shipment of any or all goods due you and cancel this and any other orders for you in case of your failure to make payments as agreed, or of any change in your credit standing. These prices are fixed—excepting if the seller's costs are increased by the imposition of government and/or state taxes, or by laws or regulations governing the working hours or compensation of labor, or by other increases in the rates of wages, in which case the buyer agrees to pay these increases. All orders subject to approval of our Philadelphia office."

During the year 1936 the partnership experimented in the manufacture of piece goods for its inventory requirements through contractors rather than purchasing finished piece goods from various weavers. The books of the partnership reflect payments of $12,523.26 and $15,196.27 to two different concerns, respectively, for spools of yarn delivered to the partnership over the period August to December 1936.

Appendix C

During the period November 1936 to February 1938 the partnership paid a weaver $5,840.62 for weaving the above mentioned spools of yarn into gabardine cloth, and paid a finisher and dyer $3,788.78 for finishing and dyeing the woven gabardine cloth. Approximately 15,000 yards of gabardine cloth were produced in this operation, and this yardage, after being sponged, was used by the partnership in the manufacture of its 1937 and 1938 spring and summer lines of finished stock.

In 1938 and 1939 the partnership engaged in the manufacture of additional piece goods for its inventory requirements through contractors. The transaction was carried out through Robert Rubenoff & Sons of New York City who were and are engaged in the business of converting wool tops purchased by clothing manufacturers and retail chain stores into finished cloth on a commission basis paid by the processors. Wool top is a blend of raw wool obtained from the various wool growing districts of the world. The blending of the raw wool into wool top is performed by a top maker.

On November 16, 1938, the partnership purchased through Robert Rubenoff & Sons 5,181 pounds of wool tops from Nichols & Co., Boston, Massachusetts, for immediate delivery to Cherry Brook Worsted Co., Woonsocket, Rhode Island. The wool tops were received by Cherry Brook Worsted Co. on November 19, 1938, and on November 23, 1938, the partnership ordered the worsted company to spin the wool tops into wool yarn. Between February 9 and February 14, 1939, the Cherry Brook Worsted Co. spun a total of 4,725 pounds of yarn, as ordered, and billed the partnership for the spinning, and, in accordance with instructions, shipped the yarn to Sterling Mills, Inc., Worcester, Massachusetts, for weaving into cloth.

The 4,725 pounds of yarn were received by Sterling Mills, Inc., between February 13 and February 16, 1939.

Appendix C

During the period February 23 to September 21, 1939, Sterling Mills, Inc., wove the total poundage of yarn into 3,888⅞ yards of finished woolen cloth, which was delivered to the partnership within this period. The partnership at all times retained title to the yarn and woven cloth. The cost per yard of the wool cloth produced and delivered was $2.20.

On September 22, 1939, the partnership purchased through E. A. Pierce & Co., at Philadelphia, Pennsylvania, 100 open contracts for the delivery of 500,000 pounds of wool tops under March 1940 wool tops futures contracts. Each of the contracts called for the delivery of 5,000 pounds of wool tops under its terms and in accordance with its provisions. The total cost of the 100 contracts was $589,955 (455,000 pounds at $1.18 per pound or $536,900 plus 45,000 pounds at $1.179 per pound or $53,055). At all times herein material the contracts were held in the name of E. A. Pierce & Co. The purchase of the contracts was made through the Wool Associates of the New York Cotton Exchange, Inc., by E. A. Pierce & Co. on the New York Wool Top Exchange. The partnership's commitment was margined at the rate of $250 per contract or $25,000 for the 100 contracts. E. A. Pierce & Co., in a letter to the partnership under date of September 22, 1939, confirmed the purchase of the contracts for the account of the partnership, as follows:

"We hereby confirm our purchase today for your account, 91 contracts of March Wool at 118.0 and 9 contracts at 117.9, (covering invoices for which will be mailed to you from our New York office), together with our understanding that you will margin these commitments at the rate of $250.00 per contract. We are not permitted, under the Rules of the New York Cotton Exchange—on which these contracts were purchased—to grant a credit extension; otherwise we would have been glad to have done so."

On the confirmation slips sent to the partnership by E. A. Pierce & Co. there was printed in small type the following:

"It is understood that the within and all other transactions made for your account by us contemplate actual receipt and delivery of the property and payment therefor and that all property sold for your account is sold upon the representation that you have same in your possession actually or potentially. These transactions are made subject to the rules, regulations and customs of the Board or Exchange on which they are made and subject to any and all Federal and/or State statutes to the extent that same may be applicable thereto. The right is reserved by us to close transactions without further notice when, in our judgment margins on deposit with us are below our requirements."

The 500,000 pounds of wool tops would produce approximately 375,000 yards of finished piece goods. Based on the processing costs incurred in the 1938 transaction, wool tops purchased at $1.18 per pound could be manufactured into piece goods at a cost of approximately $2.61 per yard.

On September 26, 1939, the partnership drew a check to the order of E. A. Pierce & Co. in the amount of $25,000 and the partnership's account with E. A. Pierce & Co. was credited with this amount. Additional deposit of margin was subsequently required which totaled $78,500 up to and including November 10, 1939.

The credit balance of the partnership appearing on the books of E. A. Pierce & Co. as of November 30, 1939, was in the amount of $103,500. On December 9, 1939, the margin was reduced by $28,500, resulting in a credit balance as of the close of the year of $75,000. During January 1940 the margin was increased to $102,000.

The wool tops futures contracts above described were

sold by E. A. Pierce & Co. on the New York Wool Top Exchange at the order of the partnership, commencing February 3, 1940, and terminating on February 16, 1940. The total sales price of these 100 contracts was $497,205. Commissions paid for selling were $3,000, and at the conclusion of the sales the account of S. Makransky & Sons on the ledger of E. A. Pierce & Co. was debited with $95,750.

The above $95,750 debited to the partnership's commodity account on the ledger of E. A. Pierce & Co. represents the total cost of the 100 contracts of $589,955, plus the commission of $3,000, less the total sales price of $497,205. The commodity account was never debited with the total cost of the 100 contracts, nor with the commission as such. Neither was it credited with the total sales price. It was simply debited with the net difference of these items as indicated above. After the account was debited with the above amount of $95,750 there remained a credit balance in favor of the partnership of $6,250 which represented the difference between the above-mentioned margin of $102,000 and the debit of $95,750. On or about February 17, 1940, E. A. Pierce & Co. sent the partnership a check for $6,250, and the partnership's commodity account on the ledger of E. A. Pierce & Co. was debited with a like amount, which entry closed out this account on the books of E. A. Pierce & Co.

The books of the partnership reflected the transactions in a manner similar to that used on the books of E. A. Pierce & Co.

The partnership did not record separately on its books the cost of the 100 contracts, the commissions charged by E. A. Pierce & Co., or the total sales price of the 100 contracts. On December 31, 1940, it merely charged the net result of these three items, namely, the above mentioned amount of $95,750, to "Woolens Purchases" and credited E. A. Pierce & Co. with a like amount, with the

explanation: "Cost of hedgings to protect purchases of woolens."

Attached to the stipulation as exhibits are balance sheets of the partnership as of December 31, 1939, and December 31, 1940, and operating statements of the partnership for the calendar years 1939 and 1940. On the balance sheet as of December 31, 1939, appeared an asset called "Deposit Commodity Futures Contract" in the amount of $75,000, which was explained in a footnote to the balance sheet as follows:

"This deposit has been made against the purchase of commodity futures at prices which were above the market quotations on December 31, 1939."

Section 75 of chapter III of the bylaws and rules of the Wool Associates of the New York Cotton Exchange, Inc., in effect during the years 1939 and 1940, provided in part as follows:

"All contracts for the future delivery of wool tops shall be in the following form:

"WOOL ASSOCIATES OF THE NEW YORK
COTTON EXCHANGE, INC.
WOOL TOP CONTRACT

New York, N. Y. .....19....

Sold Deliver to

"A. B. have this day Bought and agreed to Receive from C. D. 5,000 pounds of wool tops at the price of ..... dollars and ..... cents per pound for American find Top, Wool Top Exchange Standard, the seller having the option of delivering wool tops of other types or of inferior or superior quality at discounts and premiums, in accordance with the provisions of the By-Laws, Rules and Regulations of the Wool Associates of the New York Cotton Exchange, Inc. * * *

"Either party may call for a margin, as the variations of the market or like deliveries may warrant, which margin shall be kept good.

"This contract is made in view of, and in all respects subject to the By-Laws, Rules and Regulations of the Wool Associates of the New York Cotton Exchange, Inc.

* * * * *

"Verbal contracts (which shall always be presumed to have been made in the approved form) shall have the same standing, force, and effect as written ones, if notice in writing of such contracts shall have been given by one of the parties thereto to the other during the day on which such contract is made."

It was stipulated at the hearing that by the term "Wool Top Exchange Standard" referred to in the above mentioned uniform wool tops contract "is meant an average American fine wool top conforming to grade 64s official United States standards for wool tops, made out of merino wools, oil combed, and containing a normal percentage of 3 percent of oil including natural fat, produced from wool grown in and shorn from living animals in the United States, cleaned, scoured, carded, and combed in accordance with the methods and usages prevailing in the industry, and of average length and color."

During the years 1939 and 1940, wool tops deliverable to the purchaser under the terms of the uniform wool tops contract were restricted to wools shorn from living animals in Australia, South Africa, Argentina, Uruguay, and the United States.

Under the terms of the uniform wool tops contract wool tops blended from wools grown in woolgrowing districts of the United States were tenderable, but no other blends were acceptable. In addition, wool tops containing not more than 20 percent of pulled wools from the same country of origin and tops containing not more

than five percent of scoured wools resulting from a previous mill scouring were tenderable under the rules of the exchange.

The following wool tops were not tenderable or deliverable: (1) Tops having a mineral oil content, (2) tops combed in oil on French combs, (3) tops containing more than 1½ percent of any waste or reworked wools originating from other sources than the lot in process, (4) tops containing more than four percent oil including natural fat, or (5) tops composed of carbonized or contaminated wools.

Attached to the stipulation as an exhibit is a compilation of instructions to wool top inspectors, as amended by the board of governors of the New York Wool Top Exchange on recommendation of the Wool Top Committee, to become effective on all contracts on and after February 1, 1937.

The partnership borrowed money on short term unsecured loans to meet its pay roll and pay for the cost of its material. During the years 1938 and 1939, the partnership had an aggregate line of credit with three banks in the amount of $900,000.

The senior member of the partnership was Harry Makransky. He was responsible for buying the piece goods for the firm and for laying out its manufacturing policies. He had been in the business of manufacturing men's clothing for about 43 years. The comptroller and executive manager of the partnership is Milton Melnick. He was in charge of sales, the firm's accounting and records, the execution of its business policies, and the management of its office. He had been with the firm for over 23 years.

In the manufacture of its clothing the partnership used principally a 14 to 14½ ounce worsted cloth.

During the years 1939 and 1940 the wholesale prices for the suits manufactured by the partnership ranged

from $18 or $18.50 to $22.50. They were sold by retailers at prices between $35 to $40.

Over a period of years the partnership had established a regular clientele, including chain stores and other large concerns, which bought merchandise from it regularly each season. The partnership was an established source of supply for the large buyers, who relied on the firm to produce the goods which they required.

The war in Europe began on September 1, 1939. Following the outbreak of the war, the mills which manufactured piece goods and from which the partnership purchased the goods for their manufacturing needs withdrew all lines. No goods could be purchased.

Harry Makransky had been with the present firm, or one of its predecessors, since prior to the first World War. The business at that time also manufactured from finished piece goods and during that war he had had experience with the difficulties of obtaining the goods for manufacturing. The goods became very scarce, prices rose over 300 percent, and a poorer quality of merchandise was made.

Following the outbreak of the present war, the firm expected that its customers would continue to call upon it for their requirements and that these requirements might even increase. It was estimated that 500,000 yards of cloth a year would be required for the firm's manufacturing. In September 1939 the partnership had on hand and on order sufficient piece goods to provide the material needed to cover the firm's 1939 fall season and the 1940 spring season. With the withdrawal of all lines of piece goods in September 1939, the partnership found itself in a position where it could not make any purchases of additional cloth necessary for the continuance of the business.

Harry Makransky raised the problem with the other members of the firm and Melnick. He told them of the fact that the mills had withdrawn all lines and were not

showing any goods for sale, and discussed the bad situation in which this left the firm with respect to the future continuance of its manufacturing operations. He recalled the difficulties he had experienced during the first World War both in obtaining goods and in the prices which had to be paid. The current situation was even worse, since during the first World War goods could be purchased but now none at all were available. He wanted to do something to solve the situation and to remove the uncertainties. Various discussions were held among the members of the firm to determine what could best be done. The members concluded that the best thing to do was to buy wool tops and manufacture it into cloth. The above-mentioned purchase of the 100 contracts followed.

The plan was to take delivery of the tops in the spring of 1940. The manufacture of the partnership's 1940 Fall line would normally begin during the preceding June. Based on the partnership's prior experience, delivery of the finished piece goods could be anticipated within 60 to 90 days after delivery of the wool tops.

The partnership consulted a number of persons experienced in the business to assure themselves that facilities would be available for the spinning, weaving, and other processing of the tops into finished yarn. The partnership was assured that there would be no difficulty. It is not unusual for a manufacturer of men's clothing also to manufacture its own finished piece goods from wool tops through agents or contractors.

In their prior experience with the manufacture of their own piece goods, the partnership gave samples of cloth to the mills that make the cloth and instructed them to duplicate patterns. The samples are made up before the cloth is manufactured, being obtained from repeat numbers, mills, jobbers, and other sources. The same procedure was contemplated in the proposed new program. It was contemplated that the samples would also be fur-

nished to the salesmen for use in March and April of 1940 when they normally would sell the fall 1940 line. It would not be necessary for the salesmen to wait for the finished goods.

On September 21, 1939, Melnick telephoned the Philadelphia office of E. A. Pierce & Co., wool brokers, to inquire as to the purchase of wool tops. He was connected with Hibbard W. Roberts, an account executive. Roberts went to the offices of the partnership and discussed the matter with Harry Makransky and Melnick.

Melnick and Makransky explained their problem to Roberts and advised him of the partnership's decision to purchase wool tops to make their own worsteds to be manufactured into men's suits. They told him that their normal requirements were about 500,000 yards of cloth; that they wanted to buy 500,000 pounds of wool, which they estimated would produce about 375,000 yards of cloth, which they felt was a fair amount; and that they wanted the wool for delivery sometime in the spring, probably March. Roberts advised Melnick and Makransky of the procedure for purchasing the tops and the commissions involved; and that 500,000 pounds would require 100 contracts of 5,000 pounds each. In response to their inquiry, Roberts also informed Melnick and Makransky that the wool tops for March delivery were selling around $1.18 a pound.

Roberts was told that the partnership used a 14 to 14½ ounce worsted cloth, and that it wanted wool to make into such goods. They discussed the type of wool that would be received, and Roberts assured them that there was never any difficulty along these lines. No question was raised at this conference as to the possibility that South African Cape wool would be delivered on the contracts. Prior to that time Roberts had not experienced any difficulty in receiving deliveries of wool for such type of buyers.

If a holder of a wool contract received a type of wool which he could not use, he could retender it. The brokers would then get the type of wool he wanted and he would pay the difference in the premium. The broker sells the tops and rebuys what the contract holder can use. Melnick and Makransky were not acquainted with the details of this procedure, but they were assured and understood that there was no problem in getting a suitable wool.

Following the conference, Roberts discussed the order with his firm's research department in New York in view of the size of the order. They inquired about the type of wool the firm was using and the amount of cloth it was using, and did not seem to think that 500,000 pounds was abnormal. Roberts was authorized to accept the order, if the Philadelphia office was satisfied that S. Makransky & Sons was the type of firm with whom they usually dealt. Roberts thereafter advised Melnick that the order was acceptable to his firm. He was instructed to make the purchase, and the order was executed the next day.

Sometime after the contracts were purchased, widespread rumors developed that increased imports of Cape wool from South Africa were in prospect and that such wools would be tendered for delivery on the March 1940 contracts. Cape wool is a fast shrinking wool, used extensively in felts and velours. It is also used for women's wear, including hosiery, because of its fineness and softness. Used in the manufacture of a cloth for men's suits, the Cape wool would give the cloth a softer handle. It is not the type of cloth which large manufacturers of men's suits are acquainted with and find desirable. It was unsatisfactory for the type of clothing manufactured by the partnership.

Roberts had also learned of the rumors of increased imports of Cape wool in response to inquiries of his office as to why the future market on the exchange was selling

down. He called Melnick because this was something that he never had any experience with and which would be vital to the Makransky firm. He did not know whether they would be able to use wool from South Africa, and he wanted to put the firm on its guard. He had told Makransky that they would receive the type of wool that they wanted, but after the Cape situation arose he thought they might have difficulty in getting the type of wool Makransky wanted.

In addition to hearing the rumors that deliveries of Cape wool were in prospect, the partnership had also learned from cloth manufacturers that the South African wool was not suitable for the manufacture of the type of cloth which they used in the manufacture of their suits. This was a matter of common knowledge with the trade.

After receiving the call from Roberts, Melnick contacted Harry Makransky, who went to see Roberts. Roberts showed him the flash they had received stating that Cape wools might be received against the contracts, but told him that beyond this they were not informed on the matter. He informed Makransky that under this situation they might have difficulty in getting the type of wool they wanted.

Roberts arranged for Makransky to discuss the situation in New York with one Shlenker. Shlenker was in charge of commodities for E. A. Pierce & Co. In New York Makransky met with Shlenker and E. A. Beveridge, who was in charge of commodities' research for E. A. Pierce & Co. Shlenker and Beveridge confirmed to Makransky the rumors that there were prospects of Cape wools being delivered on the March contracts and that the contract permitted the seller to deliver such wools. Makransky stated that he could not use this type of wool in his business. Shlenker and Beveridge then took Makransky to the office of George H. Baston, in charge of the New York office of the Commodity Exchange Administra-

tion. Baston confirmed that the deliverer had the right to deliver tops from Cape wool if he so elected.

Following Makransky's visit to New York, he and the members of his firm and Melnick had a number of further discussions on the situation. Makransky made a further investigation to ascertain whether Cape wools could be used in their manufacturing. He visited a number of the firm's sources of supply, and was told they would not use Cape wools. There had been prior experimentations, and even a small amount would result in a shrinkage.

About the end of the year 1939, contrary to the situation feared in September, piece goods became more readily available, and the firm found that it could place purchases for cloth. During the month of January the market became better. The partnership decided that, since the finished piece goods now could be obtained and Capes were not suitable for their type of worsteds, they would dispose of the March contracts. They concluded that in view of the situation which had developed this was the sound business thing to do.

The partnership purchased the 100 contracts for the future delivery of wool tops as a means of acquiring the wool tops and with the intention and purpose of taking delivery of the wool tops for manufacture into piece goods which they would use in their business of manufacturing men's suits.

The partnership in its return of income for the calendar year 1940 reported an ordinary net loss of $87,808.68, which in schedule J it apportioned among its members as follows:

Dorothy Makransky	$17,561.73
Edward Makransky	17,561.74
Louis Makransky	17,561.74
Harry Makransky	17,561.74
Sadye Makransky	17,561.73

The loss of $87,808.68 was due principally to the fact that the partnership in arriving at its cost of goods sold included the above mentioned loss of $95,750 on sale of the 100 contracts as a part of its "Merchandise bought for sale" reported on its return in the amount of $1,318,319.10.

The partnership in its return of income for the calendar year 1941 reported an ordinary net income of $5,633.28, which in schedule J it apportioned among its members as follows:

Dorothy Makransky	$1,126.65
Edward Makransky	1,126.66
Louis Makransky	1,126.66
Harry Makransky	1,126.66
Sadye Makransky	1,126.65

In arriving at the above net income of $5,633.28 the partnership claimed as a deduction from gross income, among other items, an amount of $87,808.68 labeled "Net Loss Carry-over from 1940," which the respondent disallowed in determining the deficiencies herein.

The loss incurred in connection with the purchase and disposition of 1940 March wool tops futures contracts did not constitute an ordinary and necessary expense of the business of the partnership. The loss incurred in connection with the purchase and disposition of the 1940 March wool tops futures contracts did not constitute additional cost of the inventory of the partnership, nor was the loss incurred upon the sale of property which would properly have been included in the inventory of the partnership if on hand at the close of the taxable year.

The purchase of 100 March 1940 wool tops futures contracts by the partnership did not constitute a hedge by the partnership.

The loss of $95,750 sustained by the partnership during

the taxable year 1940 on the sale of the 100 wool tops futures contracts represented a loss upon the sale of a capital asset held for not more than six months.

OPINION

BLACK, *Judge*: Petitioners primarily contend that, under sections 23 (s), 122, and 189 of the Internal Revenue Code, they are entitled to carry over the 1940 loss of the partnership of $87,808.68 as a "net operating loss carry-over" in computing their individual tax liabilities for the calendar year 1941. Subsection (s) and sections 122 and 189 were all inserted in the code by section 211 of the Revenue Act of 1939. Section 122 was later amended by section 153 of the Revenue Act of 1942. As thus explained, the material provisions of these sections are set forth in the margin.[1]

The respondent contends that the loss of $95,750 on the sale of the 100 futures contracts sustained by the partner-

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[1] SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * *

(s) Net Operating Loss Deduction.—For any taxable year beginning after December 31, 1939, the net operating loss deduction computed under section 122.

SEC. 122. NET OPERATING LOSS DEDUCTION.

(a) Definition of Net Operating Loss.—As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions and limitations provided in subsection (d).

(b) Amount of Carry-Back and Carry-Over.—

(1) Net operating loss carry-back.—If for any taxable year beginning after December 31, 1941, * * *

(2) Net operating loss carry-over.—If for any taxable year the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-over for each of the two succeeding taxable years, except that the carry-over

ship in 1940 was a "short-term capital loss" as that term is defined in code section 117. If that be true, and since the partnership had no "short-term capital gains" during the calendar year 1940, there would be no net operating loss under 122 (a), no net operating loss carry-over under 122 (b), and no net operating loss deductions under 122 (c), for the reason that under the exceptions and limitations provided in 122 (d) "the amount deductible on account of short-term capital losses shall not exceed the amount includible on account of the short-term capital gains" and, therefore, instead of the deductions exceeding the gross income of the partnership for 1940 under 122 (a)

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in the case of the second succeeding taxable year shall be • • •

(c) Amount of Net Operating Loss Deduction.—The amount of the net operating loss deduction shall be the aggregate of the net operating loss carry-overs and of the net operating loss carry-backs to the taxable year reduced by the amount, if any, by which the net income (computed with the exceptions and limitations provided in subsection (d) (1), (2), (3), and (4)) exceeds, in the case of a taxpayer other than a corporation, the net income (computed without such deduction), or, in the case of a corporation • • •

(d) Exceptions and Limitations.—The exceptions and limitations referred to in subsections (a), (b), and (c) shall be as follows: • • •

(4) Long-term capital gains and long-term capital losses shall be taken into account without regard to the provisions of section 117 (b). As so computed the amount deductible on account of long-term capital losses shall not exceed the amount includible on account of the long-term capital gains, and the amount deductible on account of short-term capital losses shall not exceed the amount includible on account of the short-term capital gains: • • •

SEC. 189. NET OPERATING LOSSES.

The benefit of the deduction for net operating losses allowed by section 23 (s) shall not be allowed to a partnership but shall be allowed to the members of the partnership under regulations prescribed by the Commissioner with the approval of the Secretary.

by $87,808.68, the gross income would exceed the deductions by $7,941.32. Petitioners, however, contend that the loss of $95,750 was not a short term capital loss, but was an ordinary business loss, or, in the alternative, an ordinary and necessary business expense deductible under code section 23 (a), as amended by section 121 of the Revenue Act of 1942, or as additional cost of goods actually taken into inventory during the year 1940. The material provisions of code sections 117 and 23 (a), as amended, are also in the margin.[2]

Was the loss of $95,750 on the sale of the 100 futures contracts a short term capital loss? The answer depends upon whether such contracts were or were not "capital assets" as that term is defined in code section 117. Under this definition the term "means property held by the

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[2] SEC. 117. CAPITAL GAINS AND LOSSES.

(a) Definitions.—As used in this chapter—

(1) Capital Assets.—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l);

* * * * *

(3) Short-term capital loss.—The term "short-term capital loss" means loss from the sale or exchange of a capital asset held for not more than 18 months, if and to the extent such loss is taken into account in computing net income.

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) Expenses.—

(1) Trade or business expenses.—

(A) In General.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *

taxpayer" with certain specified exceptions. These exceptions are (1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or (2) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or (3) property used in the trade or business of a character which is subject to the statutory allowance for depreciation.

Petitioners contend that the contracts fall within the first exception as representing property of a kind which would properly be included in the inventory of the partnership if on hand at the close of the year. They argue that if, as originally intended, the partnership had taken delivery of the wool tops, and the wool tops had been on hand at the close of the year, there would be no question as to the inclusion in the inventory of the wool tops. Because of changed conditions, namely, the influx of Cape wools, and the availability again of piece goods, the partnership decided not to take delivery of the wool tops but to dispose of the futures contracts instead. Petitioners further argue that it is difficult to see a legal or practical justification for drawing a distinction between the tax treatment to be given losses realized on the disposition of materials physically taken into inventory and losses realized where futures contracts are disposed of before actual receipt of the commodities specified in the contracts due to a change in conditions over which the partnership had no control.

In *Anna M. Harkness*, 1 B. T. A. 127, 130, this statement appears:

It seems to us to be fundamentally unsound to determine income tax liability by what might have taken place rather than by what actually occurred. Even though the practical effect may be the same in either

case, the resulting tax liability may be quite different. *United States* v. *Isham*, 17 Wall. 496.

In the instant proceedings what actually occurred was a purchase and sale of futures contracts. It is well settled that such contracts are not to be included in the inventory. See sec. 19.22 (c)-1, Regulations 103; A. R. R. 100, C. B. No. 3, p. 66; A. R. M. 135, C. B. No. 5, p. 67; *Commissioner* v. *Covington*, 120 Fed. (2d) 768, 771; certiorari denied, 315 U. S. 822; *Tennessee Egg Co.*, 47 B. T. A. 558. In fact the partnership did not include the contracts in its inventory at the close of the year 1939 and it would have been improper to have done so. The only account it had on its books at that time relative to the contracts in question was the account with E. A. Pierce & Co. showing a debit balance of $75,000 for the margins that were up at that time. Neither were the futures contracts stock in trade nor property held primarily for sale to customers in the ordinary course of the partnership's trade or business. *Commissioner* v. *Covington*, *supra*. It is obvious that the contracts were not property of a character which is subject to the statutory allowance for depreciation, and we do not understand petitioners to so contend. The contracts were held by the partnership for less than 18 months. It follows, therefore, that the loss of $95,750 was a short term capital loss, unless it resulted from a true hedge as that term is commonly and usually understood. That brings us to petitioners' alternative contention that the loss was an ordinary and necessary business expense, because it was incurred in hedging operations.

It has long been the practice of the Commissioner and the courts to treat losses from hedging transactions as essentially insurance and deductible as ordinary and necessary business expense rather than losses from dealings in capital assets. See G. C. M. 17322, C. B. No. XV-2, p. 151; *Ben Grote*, 41 B. T. A. 247; *Commissioner* v. *Farm-*

ers & Ginners Cotton Oil Co., 120 Fed. (2d) 772; *Kenneth S. Battelle*, 47 B. T. A. 117. "Losses from true hedges are allowed in full." *Commissioner* v. *Farmers & Ginners Cotton Oil Co., supra.* In that case the Fifth Circuit also said:

"A hedge is a form of price insurance; it is resorted to by business men to avoid the risk of changes in the market price of a commodity. The basic principle of hedging is the maintenance of an even or balanced market position. To exercise a choice of risks, to sell one commodity and buy another, is not a hedge; it is merely continuing the risk in a different form. * * *"

In G. C. M. 17322, *supra*, relating to the treatment of hedging transactions for Federal income tax purposes, after describing the hedging customs of a certain cotton textile manufacturer, it is said:

"Such hedges, which eliminate speculative risks due to fluctuations in the market price of cotton and thereby tend to assure ordinary operating profits, are common trade practices and are generally regarded as a form of insurance (the only kind available as protection against such risks) necessary to conservative business operation.

"Where futures contracts are entered into only to insure against the above-mentioned risks inherent in the taxpayer's business, the hedging operations should be recognized as a legitimate form of business insurance. As such, the cost thereof (which includes losses sustained therein) is an ordinary and necessary expense deductible under section 23 (a) of the Revenue Act of 1934 and corresponding provisions of prior Revenue Acts. * * *"

Petitioners contend that the partnership's situation relative to the futures contracts was similar to the situation relative to the "futures transactions (short) in *cotton* during 1936" in *Kenneth S. Battelle, supra.* We fail to

see any similarity between the two situations. It is true that on its books of account the partnership on December 31, 1940, charged the loss of $95,750 to "Woolens Purchases" and credited E. A. Pierce & Co. with a like amount, with the explanation: "Cost of hedgings to protect purchases of woolens."

Petitioner was and is a manufacturer of men's suits from piece goods purchased from worsted mills. The partnership sold its finished products to retailers who were contracted seasonally by its various salesmen. There is no evidence that petitioner used a method of hedging against present sales of its clothing suits by the purchase of future wool tops contracts. On the contrary, the evidence seems to show conclusively that the purchase of the 100 wool tops contracts in September 1939, which it disposed of in February 1940, was not a balancing transaction against sales of clothing, but was an isolated transaction and one made because of the more or less panicky condition which arose after the outbreak of the war in September 1939 respecting the future supply of woolen piece goods. The transaction turned out badly for petitioner and the loss which it suffered could be carried over as an ordinary business net loss and used as a deduction in the next taxable year were it not for the provisions of the statute which we have quoted in the margin. In view, however, of the statutory definition of capital assets, we feel we must hold that the wool tops contracts were capital assets and that the partnership's transactions in these contracts did not represent hedging transactions as that term is ordinarily understood, and petitioners' loss in the transactions must be adjudged a short term capital loss. *Commissioner* v. *Farmers & Ginners Cotton Oil Co., supra.* Certainly, in the latter case, the transactions of the taxpayer more nearly resembled a true hedge than those of the instant case, yet the court held against the taxpayer.

It follows from what we have said that the respondent's several determinations in these consolidated proceedings must be sustained and that petitioners are not entitled to deduct from their 1941 income any net operating loss carry-over on account of the partnership's wool tops futures contracts.

Reviewed by the Court.

Decisions will be entered for the respondent.

OPPER, *J.*, dissents.

[*Dissenting Opinion*]

SMITH, *J.*, dissenting: The partnership of S. Makransky & Sons, Inc., had a loss in 1940 from the sale of certain contracts for the purchase of wool tops for delivery at a future date. It apprehended, due to war conditions, that it would be unable to secure woolen cloth for its requirements for the manufacture of men's suits. To insure itself a supply of such cloth it purchased the contracts in question. Early in 1940 it was apparent that the apprehended scarcity would not materialize; also that the wool tops which might be delivered to it under its contracts would be of an inferior grade. This being so, it sold its future contracts in February 1940, sustaining a loss upon the transaction of $95,750. The opinion of the Tax Court is that the loss is not a legal deduction from gross income upon the ground that it was a short term capital loss and that, since the partnership had no short term capital gains, the deduction of the loss must be disallowed.

It seems to me that the result is unjustified. It certainly should not be reached unless the wording of the statute requires it. Clearly, the investment in the wool tops futures was an ordinary business operation. At the time the contracts were purchased the partnership

expected to take delivery of the wool tops. It was simply insuring itself against an apprehended scarcity of material. If the partnership had taken delivery under its contracts and then sold the woolen tops there would be no question, I think, but that the loss which might have been sustained would be a legal deduction from gross income.

The situation is comparable to that of a corporation which contracts for the purchase of automobile trucks or other machinery to be delivered in the future. Before the time for delivery the corporation finds that it can purchase its requirements of trucks and machinery from another source possibly more advantageously. It therefore gives a certain amount for the rescission of its contract or sells its right for the delivery of the machinery to other parties at a loss. It would seem to me that in such a situation the claimed deduction would be an ordinary and necessary business expense. Every consideration of justice and fair play as between the taxing authority and the taxpayer argues for the allowance of the deduction. It seems to me that it is highly hypertechnical to disallow the deduction as an ordinary and necessary expense.

The Tax Court rejects the petitioners' claim that the amount is deductible as an ordinary and necessary expense. It then says that the amount cannot be deducted at all because it was a short term capital loss against which the petitioner had no short term capital gains for the year 1940. It says that the loss did not arise from a hedging transaction and that therefore the loss may not be deducted, in accordance with *Commissioner* v. *Farmers & Ginners Cotton Oil Co.*, 120 Fed. (2d) 772; certiorari denied, 314 U. S. 683. In that case it was held that where a dealer in cottonseed oil bought refined oil futures because it had insufficient storage facilities for crude oil and had been compelled to sell crude oil at unsatisfactory prices, it merely exchanged its market risk from crude to

refined oil, and losses were not deductible in their entirety in computing income tax, since they did not result from true "hedges," notwithstanding price relation between crude and refined oil. The court found:

"* * * Petitioner could have demanded delivery of refined oil under any futures contract, but made no such demand, and the contracts were entered into by it with the intention not to demand or receive such delivery. * * *"

The facts in that case were somewhat different from those which obtain in the instant proceeding; for here the partnership did intend to take delivery upon the wool tops at the time it purchased the futures contracts.

In the above referred to case the Tax Court decided that the taxpayer was entitled to deduct its loss. 41 B. T. A. 1083. Our decision in that case was reversed by a divided court. The Supreme Court denied a writ of certiorari. But the Supreme Court has many times said that the denial of a writ of certiorari is not tantamount to the affirmance of the decision of the lower court.

It may at once be admitted that an ordinary hedging transaction is one where a person attempts to hedge against a loss by the purchase or sale of a future contract on the stock exchange or a commodity exchange. But I do not think that a hedging contract should be limited to that defintion. The partnership with which we are here concerned attempted to hedge against a loss in business operations for 1940 by securing for itself a supply of wool tops from which it could have cloth for the manufacture of men's suits. That seems to me to be as much a hedging contract as one where the contract is simply to protect one's self against a fluctuation in price. It seems to me that it was in essence a hedging contract.

Furthermore, I do not think that the definition of capital gains was ever intended to apply to a contract of this character. To be sure the partnership when it purchased

the future contracts in 1939 had a species of property. It had an investment in the contracts and, undoubtedly, at some time after the purchase it could have sold those contracts to recover back at least a part of the amount it had invested in them.

The situation here seems to me to be comparable to that which obtained in *Palmer v. Commissioner*, 302 U. S. 63. In that case the taxpayer had received warrants from the American Superpower Co. entitling him to purchase from it shares of stock in other corporations which it owned. The rights had a large market value at the time they were received by Palmer. He exercised the rights and acquired the shares. The Commissioner determined that Palmer received taxable income by the receipt of the warrants to the extent of their value. The Board of Tax Appeals reversed his determination and that reversal was sustained by the Supreme Court. That Court simply gave a sensible construction to the statute and held that Palmer did not derive taxable income merely from the receipt of the warrants.

So here, I think that we should give a sensible construction to the statute and hold that the net income of the partnership for 1940 was what remained after the deduction of the loss sustained on the sale of the future contracts for the purchase of the wool tops.

LEECH, *J.*, dissenting: In general I agree with the foregoing dissent. Since some of my reasons for dissenting may be different, it may be well to state them.

The propriety of the disputed "net operating loss carryover" turns on the deductibility of a very real loss petitioners sustained in the transaction in wool "futures." Sec. 122, I. R. C. This loss, if deductible at all, must be so as a "hedge" and therefore a business expense, or as an ordinary loss. The majority holds it is neither. I disagree.

Appendix C

Futures transactions, in order to be classified as a true "hedge," need not occur in any particular step of the business cycle in which the taxpayer is engaged. The term means a form of insurance of the profits of a business. So, if the "futures" were purchased by the partnership to insure the profitable conduct of any step in *its* business, they were a true "hedge." See *Commissioner* v. *Farmers & Ginners Cotton Oil Co.*, 120 Fed. (2d) 772; certiorari denied, 314 U. S. 683.

The majority opinion is premised upon, *inter alia*, the following finding of fact:

> The partnership purchased the 100 contracts for the future delivery of wool tops as a means of acquiring the wool tops and with the intention and purpose of taking delivery of the wool tops for manufacture into piece goods which they would use in their business of manufacturing men's suits.

This finding affords substantial, if not incontrovertible, proof of the fact that the purchase of the "futures" here was not in reality a purchase of "futures contracts" at all, but rather the first step in the actual and intended purchase of the wool itself for future delivery. If so, this wool would have been excluded from "capital assets" by the first exception in the definition of that term appearing in section 117 (a) (1) of the Internal Revenue Code, and its sale would have resulted in an ordinary and not a capital loss.

In my opinion, the transaction in "futures" here was either a true "hedge" or resulted in an ordinary loss. In either event the amount of this actual loss was deductible in the computation of the "net loss carry-over." The case of *H. Elkan & Co.*, 2 T. C. 597, if not distinguishable on the facts, I think should be overruled.

MELLOTT, *J.*, agrees with this dissent.

Appendix C

FARMERS & GINNERS COTTON OIL COMPANY, PETITIONER, v. COMMISSIONER OF INTERNAL REVENUE

Docket No. 93436, March 3, 1942.

Lee C. Bradley, Jr., Esq., for the petitioner.

Claude R. Marshall, Esq., for the respondent.

MEMORANDUM OPINION

MURDOCK:

The decision of the Board pursuant to its findings of fact and opinion published at 41 BTA 1083 was reversed by the United States Circuit Court of Appeals for the Fifth Circuit. A mandate simply reversing the decision of the Board has been received. The Board placed the proceeding upon its calendar on a certain day and directed the parties on or before that time to submit computations of the tax liability of the petitioner consistent with the opinion of the Court or otherwise move with respect to the case. The Commissioner submitted a computation, and the petitioner filed a motion asking the Board "to find appropriate facts with respect to the question whether contracts for the purchase of refined cottonseed oil or the refined cottonseed oil to be purchased pursuant thereto are property of a kind which should properly be included in the inventory of the Petitioner if on hand at the close of the taxable year, and to enter its decision after consideration of the question involved and in the light of the finding so made." The findings of fact which appear in the report of the Board contain all of the facts that the record justifies in regard to the contracts for the future delivery of refined cottonseed oil. The petitioner is claiming now, as it claimed previously, that those con-

tracts were property of a kind which properly should be included in inventory if on hand at the close of the taxable year. That question was not decided by the Board or the Appellate Court, and therefore, it must be considered and decided now.

The petitioner purchased futures in refined cottonseed oil, that is, it purchased contracts for the delivery of refined cottonseed oil at some specified date in the future. It made the purchases on margin. It had no customers of its own in respect to the sale of the futures contracts and those contracts were neither stock in trade nor property held by the petitioner primarily for sale to customers in the ordinary course of its trade or business. These matters are all set forth in the prior report of the Board. The petitioner still contends that the contracts were inventoriable. It relies upon various rulings and several court cases, but those rulings and court cases are distinguishable on their facts. Owners actually dealing in a commodity which is being held for them in a warehouse have been allowed to inventory the commodity. Heiner v. Mellon, 304 U. S. 271; Roney v. Commissioner, 67 F. (2d) 165. Cf. G. C. M. 1582, VI-1 C. B. 171. They were the owners of the goods in question at the end of the year. The petitioner in this case, at the end of the year, would have had merely a contract for delivery at some future time. The goods involved in that contract might not even be in existence at the end of the year. The petitioner was not in fact dealing in the commodity covered by the contracts. George W. Covington, 42 BTA 601, affirmed on this point 120 F. (2d) 768. G. C. M. 18658, C. B. 1937-2, p. 77 permits goods on hand to be inventoried by persons in a position similar to that of dealers. That ruling does not apply to this petitioner.

G. C. M. 17322, XV-2 C. B. 151 is to the effect that the capital gain and loss provisions apply to all futures contracts that are speculative, as distinguished from true

hedges. The Circuit Court has held that the transactions of this petitioner were not true hedges. Thus, the memorandum referred to supports the Commissioner rather than the petitioner. The case most nearly in point is likewise against the petitioner. Staerker, Admr., v. United States, an unreported decision of the District Court for the Northern District of Texas, handed down on December 23, 1938 and appearing in 23 AFTR 1284. It is our opinion that the futures would not have been inventoriable by the petitioner if on hand at the end of the year. A decision will be entered in accordance with the computation filed by the respondent.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER, v. FARMERS & GINNERS COTTON OIL COMPANY, RESPONDENT

United States Circuit Court of Appeals for the Fifth Circuit.

No. 9802. Filed June 9, 1941.

Petition for Review of Decision of the United States Board of Tax Appeals (District of Alabama).

Edward H. Hammond and Sewall Key, Sp. Assts. to Atty. Gen., Samuel O. Clark, Jr., Asst. Atty. Gen., and J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and C. R. Marshall, Sp. Atty., Bureau of Internal Revenue, all of Washington, D. C. for petitioner.

Lee C. Bradley, Jr., and A. J. Bowron, Jr., both of Birmingham, Ala., for respondent.

Before Foster, Hutcheson, and Holmes, Circuit Judges.

Appendix C

HOLMES, *Circuit Judge.*

The question for our decision is whether losses which the taxpayer sustained on contracts for future deliveries of refined cottonseed oil were capital losses under Sec. 117(d) of the Revenue Act of 1934, 26 U. S. C. A. Int. Rev. Acts, page 708, or ordinary and necessary business expenses under Sec. 23(a) of said act, 26 U. S. C. A. Int. Rev. Acts, page 671.

The respondent taxpayer is a corporation. It buys cottonseed, crushes it, and sells the products derived therefrom. One of such products is crude cottonseed oil, which deteriorates rapidly, especially in warm weather. The respondent's storage facilities for crude oil are not more than one-sixth of its annual production, and larger storage facilities would be uneconomical. Because of these circumstances, respondent does not retain its crude oil until it can obtain what it regards as a favorable price, but sells during the operating season at the market price whenever its storage tanks are full. When forced to sell its crude oil at prices which it deems unsatisfactory, it is respondent's practice to buy, on margins, refined oil for future delivery, which later it sells before the delivery date.

There is no futures market for crude oil, but there is a direct relationship in the market price between the crude and the refined oil. The market price of the former is determined in large part by the market price of the latter plus freight to the refinery, the cost of refining, the loss in refining, and such other expenses, if any, as are incident to the operation of converting crude into refined oil. The customary practice followed by respondent during the tax year was first to sell the crude oil at the prevailing market price, and then to place orders with brokers to purchase futures on a produce exchange. If orders could not be filled readily at the price designated by respondent,

the orders were carried until purchases could be made at such prices. Such purchases were sometimes made weeks later than the corresponding sales of crude.

Crude oil loses about nine per cent in weight in the process of being refined. In the fiscal year ending June 30, 1936, petitioner sold 2,940,000 pounds of crude oil at prices unsatisfactory to it, and made purchases of 2,760,000 pounds of refined-oil futures. 2,760,000 pounds of refined oil is the approximate equivalent in pounds of 3,033,000 pounds of crude oil. The quantity unit, both in the transactions in crude and refined oil, is a tank of 60,000 pounds. During the taxable year the market price of crude oil averaged approximately nine cents a pound, or $5,400 per tank. Refined-oil futures were bought on margins of about $300 per tank. Petitioner could have demanded delivery of refined oil under any futures contract, but made no such demand, and the contracts were entered into by it with the intention not to demand or receive such delivery. Its transactions in this respect consisted entirely of purchases and sales of refined oil for future delivery, the contracts for which were terminated before the date agreed upon for delivery. Futures contracts for refined oil require no investment for storage, transportation, or insurance. Accordingly, about $300 per tank plus brokerage commissions constituted petitioner's initial investment under the futures contracts.

The Board found that transactions in such commodity for future delivery were entered into by respondent solely as a protective measure against sales of crude oil which it was compelled to make at prices deemed unsatisfactory, since it was able to maintain a position in respect of future market conditions of refined oil which it was powerless to maintain in respect of crude oil; that such futures contracts were bought and sold only on produce exchanges through brokers, and that petitioner had no customers of its own in respect thereof; that such contracts were not

stock in trade, and were not property held by respondent primarily for sale to customers in the ordinary course of its trade or business.

In the taxable year, petitioner sustained a loss of $24,024 in its transactions in refined oil, bought and sold for future delivery, and deducted the amount of such loss from its gross income. The petitioner contends that the losses in question resulted from the sale of capital assets, and disallowed as a deduction so much thereof as exceeded $2,000 plus capital gains. Respondent contends that the losses it sustained in such dealings in refined oil were normal business losses. The claim is based primarily on the hypothesis that the initial processing of raw cottonseed is so related to the manufacture of refined cottonseed oil as to make stocks of the latter product invoiceable as regular "stock in trade" of the processor. Secondarily, it contends that, in any event, its dealings in oil futures were transactions entered into for profit, and that the resulting losses are deductible, under Sec. 23(f) of the Revenue Act of 1934, as having been sustained during the taxable year and not compensated for "by insurance or otherwise."

(1,2) The petitioner concedes respondent's loss, but contends that its investments in refined oil for future delivery were capital assets within the definition set out in paragraph (b) of Sec. 117 of the Revenue Act of 1934. Losses on commodity exchanges from dealings such as these may be said to fall into three general classes: hedges, wagering contracts, and legitimate capital investments.[1] Losses from true hedges are allowed in full.[2] Wagering losses are allowed only to the extent of gains

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[1] United States v. Coffee Exchange, 263 U. S. 611, 619, 44 S. Ct. 225, 68 L. Ed. 475.

[2] Grote v. Commissioner, 41 B.T.A. 247.

from wagering contracts.[3] Capital losses are allowed only to the extent of $2,000 plus the gains from sales or exchanges.[4] In this case[5] the Board allowed the full amount as true hedging losses, citing its decision in Grote v. Commissioner, supra. There is no claim that these were wagering contracts; it would not help respondent if they were; and the presumption is that they were not. We have this day held that losses from executory commodity futures-contracts were capital losses.[6] Therefore, we need only examine the contention of the taxpayer, which was upheld by the Board, that the losses in controversy resulted from true hedges.

(3) A hedge is a form of price insurance; it is resorted to by business men to avoid the risk of changes in the market price of a commodity. The basic principle of hedging is the maintenance of an even or balanced market position. To exercise a choice of risks, to sell one commodity and buy another, is not a hedge; it is merely continuing the risk in a different form. That is what the taxpayer did in this case. It did not retain its crude oil and sell refined; it sold crude and bought refined when it had no actual commodity on hand or future commitments to be protected from price variations.

(4) Conceding that there is a price relation between crude and refined oil, the respondent merely exchanged its market risk from crude to refined. It may have sold crude at prices which were unsatisfactory to it, but the purchase of refined gave it no price insurance against future fluctuations in the market. The respondent was

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[3] Sec. 23(g), Act of 1934, 48 Stat. 689, 26 U. S. C. A. Int. Rev. Acts, page 672.

[4] Sec. 117(d), Act of 1934, 48 Stat. 715, 26 U. S. C. A. Int. Rev. Acts, page 708.

[5] 41 B.T.A. 1083.

[6] Commissioner v. Covington, et al., 5 Cir., 120 F. 2d 768, decided June 9, 1941.

not a manufacturer of refined oil. It had no crude or refined oil on hand when it bought or sold the futures from which the losses in controversy were incurred. These losses did not result from true hedges, and the decision of the Board of Tax Appeals is reversed.

HUTCHESON, *Circuit Judge*, dissents.

FARMERS & GINNERS COTTON OIL COMPANY, PETITIONER v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 93436. Promulgated May 8, 1940.

CAPITAL ASSETS-HEDGING.—Purchases and sales of refined cottonseed oil futures by a manufacturer of crude cottonseed oil made entirely as a hedge or protection against the forced sale of perishable crude cottonseed oil at unsatisfactory prices, *held*, to relate directly to its business of the manufacture and sale of crude cottonseed oil, and losses sustained in such transactions were not capital losses subject to the deduction limitation of section 117 of the Revenue Act of 1934.

E. L. All, Esq., *A. J. Bowron, Jr., Esq.*, and *Virden Moore, Esq.*, for the petitioner.

Stanley B. Anderson, Esq., for the respondent.

The Commissioner determined a deficiency of $3,019.05 in the petitioner's income tax for the fiscal year ended June 30, 1936. The issue for decision is whether losses of $24,024.30 which the petitioner sustained on contracts for future deliveries of refined cottonseed oil were capital losses subject to the $2,000 limitation of section 117 of the Revenue Act of 1934, or whether they were ordinary losses or ordinary and necessary business expenses deductible in their entirety.

Appendix C

FINDINGS OF FACT.

The petitioner is a corporation, organized under the laws of Alabama. Its principal office is in the city of Birmingham.

It is engaged in the business of operating a cottonseed oil mill. That is, it buys cottonseed, crushes the seed, and sells the products derived therefrom, consisting of crude cottonseed oil, meal, linters, hulls, fibers, and bran. The crude cottonseed oil is perishable and deteriorates rapidly, especially in warm weather. The crude oil storage facilities of the petitioner held not more than one-sixth of the annual production of the mill. Larger storage facilities were impractical not only because of the expense but also because the oil would deteriorate if held. The petitioner, because of these circumstances, could not retain its crude oil until it could obtain what it regarded as a favorable price, but had to sell during the operating season at the market price whenever its storage tanks were full.

The practice of the petitioner has been to buy futures in refined oil when, but only when, it was forced to sell crude at prices which it regarded as unsatisfactory. Refined cottonseed oil may be kept for long periods and has a market throughout the year on produce exchanges. There is a direct relationship between the market price of refined oil and the market price of crude oil as of any given date. The petitioner purchased quantities of refined oil for future delivery only to offset the sale of like quantities of crude at prices which it regarded as unsatisfactory. It would first sell the crude at prevailing market price and then place orders with brokers for the purchase of refined futures at prices named by the petitioner. Sometimes several weeks would intervene before the purchases could be made at the prices named. The practice of buying futures was generally followed by others engaged in the same line of business as the petitioner.

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The petitioner sold 2,280,000 pounds of crude during the taxable year at prices satisfactory to it and made no offsetting purchases of futures in regard to those sales. It sold the following quantities of crude on the dates mentioned at prices unsatisfactory to it:

Date	Pounds
10/16/35	180,000
10/16/35	420,000
10/18/35	60,000
10/22/35	300,000
10/22/35	180,000
10/25/35	60,000
10/28/35	180,000
10/30/35	360,000
11/20/35	300,000
12/ 6/35	180,000
12/ 6/35	120,000
1/ 8/36	600,000

It purchased futures of refined to offset those sales, and its dealings in those futures are shown in the following table:

Date Acquired	Date Sold	Quantity Pounds	Losses
11/22/35	4/13/36	180,000	$2,462.13
11/22/35	4/13/36	120,000	1,653.42
11/26/35	4/13/36	180,000	2,336.13
11/26/35	4/13/36	120,000	1,545.42
1/ 9/36	4/13/36	300,000	1,328.55
1/ 9/36	4/13/36	180,000	887.13
1/ 9/36	4/13/36	120,000	615.42
1/ 9/36	4/13/36	120,000	639.42
1/ 9/36	4/13/36	180,000	959.13
2/ 7/36	4/13/36	60,000	331.71
2/ 7/36	4/13/36	300,000	1,658.55
12/12/35	4/13/36	120,000	1,521.42
12/12/35	4/13/36	60,000	736.71
12/17/35	4/18/36	120,000	1,389.42
12/17/35	4/21/36	60,000	766.68
12/19/35	4/21/36	60,000	766.68
12/20/35	4/21/36	120,000	1,545.36
12/28/35	4/21/36	60,000	772.68
1/ 9/36	6/25/36	300,000	2,108.34
Total		2,760,000	$24,024.30

Appendix C

The petitioner bought the futures on margin. The quantity unit in transactions in crude and refined oil is a tank of 60,000 pounds. The rules of the exchange on which the futures were purchased provide that purchases "of commodities for future delivery are made with the distinct understanding that actual receipt and/or delivery is intended", but the petitioner never took delivery of any of the refined. Instead, it sold its contracts for future delivery.

The practice of buying features was a more efficient and less expensive way for the petitioner to await more favorable markets than the alternative of having its crude oil manufactured into refined and held in storage as its own property. Purchase of cottonseed was not a practical method of protecting the petitioner against sales at unfavorable prices.

The petitioner entered into the transactions in futures solely as a protection against sales of crude oil which it was compelled to make at prices which it deemed unsatisfactory, and those transactions enabled it to maintain a position in respect to future market conditions of refined oil which it was powerless to maintain in respect to crude oil.

The futures were bought and sold by the petitioner only on the New York Produce Exchange, through brokers. The petitioner had no customers of its own in respect thereto. The contracts were neither stock in trade nor property held by the petitioner primarily for sale to customers in the ordinary course of its trade or business.

The petitioner on its income tax return for the taxable year claimed deductions for the losses sustained in its transactions in futures. The Commissioner held that the losses resulted from sales of capital assets and limited the deduction to $2,000.

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OPINION.

MURDOCK: The question here is substantially the same as that considered in the case of *Ben Grote*, 41 B. T. A. 247. The only purpose which the petitioner had in buying the futures in refined oil was to attempt to avoid loss upon the crude oil which it was manufacturing. This method was as effective a hedge against loss on its operations as was available to the petitioner. Its raw material was cottonseed, but there was no futures market for that and no hedge could be made by purchases thereof. It did not buy the futures merely as a speculation, but solely to replace its manufactured product which it was forced to sell at a price which it deemed unsatisfactory. All of the transactions were directly related to its business of production and sale. The question of whether or not it could have inventoried the contracts for future delivery of refined oil need not be decided. Cf. G. C. M. 18658, C. B. 1937-2, p. 77. We pointed out in the *Grote* case that the Commissioner has interpreted and administered section 117 as excluding hedging transactions, citing G. C. M. 17322, C. B. XV-2, p. 151. The facts in this case disclose no satisfactory basis for distinguishing it from the *Grote* case and on that authority we hold that the petitioner is entitled to a deduction of $24,024.30 as losses sustained in connection with its business for the taxable year.

This opinion supersedes that promulgated on February 6, 1940, 41 B. T. A. 255.

Reviewed by the Board.

Decision will be entered under Rule 50.

HILL, dissenting: I am unable to agree with the conclusion reached in the majority opinion. The business

of petitioner was the operation of a cottonseed oil mill. That business was confined to buying and crushing cottonseed and selling the products derived therefrom, including crude cottonseed oil. Petitioner's business did not include the processing of crude into refined oil. Its dealings in futures contracts for refined oil were transactions involving mere investment in, and sale of, capital assets having no identity with the products manufactured by petitioner. Refined oil is a distinct and separate commodity from crude oil, notwithstanding the latter is an intermediate source of the former. The manufacturing operations of petitioner did not extend to the production of refined oil and its business operations were completed when it sold the products it manufactured.

Petitioner contends that the initial processing of crude oil is so related to the manufacture of refined oil as to make stocks of the latter product invoiceable as regular "stock in trade" of the processor. It further contends that its transactions in refined oil futures were essentially a part of a process of production or other acquisition of property for sale to customers in the ordinary course of its trade or business.

The first of these contentions has no factual basis of application in this proceeding. Petitioner had no refined oil to invoice either as stock in trade or otherwise and the evidence herein discloses that its intention in dealing in refined oil futures was not to take delivery of oil, notwithstanding it could have demanded and received delivery under the terms of the futures contracts. Its transactions in refined oil futures were merely executory contracts to purchase, which it acquired with a positive intent not to close into completed purchases and not to acquire any commodity thereby.

The second of the above cited contentions of petitioner is (a) that its transactions in refined oil futures were a part of a process of production or (b) other acquisition

of property for sale to customers in the ordinary course of its trade or business. As to subdivision (b) of this contention, attention is directed to the fact that by the purchase of such futures contracts the only property acquired was the contracts, which were bought and sold through brokers on petitioner's own account only and not for customers. They were merely choses in action and represented neither stocks of oil nor any other commodity includable in an inventory of stock in trade. By subdivision (a) of such second contention petitioner obviously means that its transactions in refined futures contracts were a part of the process of production of crude oil. The gist of its supporting argument on this point is that transactions in such futures contracts were necessary to enable petitioner to maintain its position in the oil market, due to the fact that rapid deterioration of crude oil compels its sale shortly after production, regardless of the state of the market. Since, as is found, there is a direct relationship between the market price of crude and refined oil, the purpose of petitioner in maintaining a position in the oil market by purchasing refined oil futures is to enable it to indulge in the speculation that at some future time there may be a better market for oil than when it sold crude. Such speculation also involves, of course, the risk that instead of improving, the market price may descend to a still lower level. If, as is argued for petitioner, its purpose in buying refined oil futures was to maintain the same position it would have had in the oil market if it had not been forced to sell its crude oil on an unsatisfactory market, it failed to accomplish that purpose.

The purchasing of futures contracts at or following the times of corresponding sales of crude oil did not operate as an unbroken maintenance of petitioner's position in the oil market. It left a hiatus between the dates of sales of crude oil and the delivery dates of the futures con-

tracts. Hence, it can not be said that the futures contracts accomplished the purpose which petitioner acclaimed, namely, to maintain its position in the oil market. That purpose could have been effectuated by purchasing spot refined oil at the related market prices at the times of corresponding sales of crude oil and by adding such refined oil to its inventories and to its stock in trade for sale to its customers in the ordinary course of trade or business. That, however, would not have been insurance or protection against investment risks. It would have afforded only an opportunity for speculation on future oil prices. But such stocks of refined oil would not have been within the classification of capital assets and any losses resulting in respect thereof would have been deductible in full for income tax purposes. This course would have at least continued petitioner's status in the oil market on the same relative price basis as if it had been able to hold its crude oil. Since petitioner did not adopt this course it can not successfully contend that its purpose was to replace crude oil with refined oil. Petitioner did not seek to maintain its position in the oil market through the replacement of inventories of crude oil with those of refined oil but first closed out its investment in its crude oil inventories and thereafter made corresponding purchases of refined oil futures contracts which bore no protective relationship to any existing or prospective investment risk. Furthermore, the market prices at which the futures contracts were purchased were the then present prices of future deliveries and had no relation to the market prices at which the corresponding sales of crude oil were made. The purchases of such futures contracts were, therefore, wholly speculative transactions. In view of the purely speculative character of all transactions in futures contracts (except as hedges), it appears to me that, unless such futures contracts constitute hedges against petitioner's business investment

risks, they can not be said to be a part of petitioner's process of production.

Petitioner does not claim that its transactions in futures contracts possessed all of the elements of a hedge, but it claims that they had a protective purpose and relationship to its business and operations. It is my opinion that such transactions had none of the elements of a hedge and in no way afforded insurance or protection against petitioner's existing or prospective investment risks, either in its raw materials or its crude oil. The purchase of such futures contracts operated only to create new and additional investments, fraught with new and additional investment risks, without any counterbalance of a hedge.

The statute has no provision excluding hedging transactions from the operation of the provisions of section 117 of the Revenue Act of 1934, but the Treasury Department has construed such section as excluding from its operation hedging transactions. G. C. M. 17322, C. B. XV-2, p. 151. The discussion and illustration of hedges set forth therein do not include, as constituting a hedge, the state of facts in the instant proceeding. Two examples are given therein as illustrating typical situations in which protection is obtained by the use of hedging transactions, as follows:

(1) The taxpayer buys quantities of spot cotton, which will necessarily be on hand for some months before being manufactured into goods and sold. In order to be protected against losses which would be incurred if the cotton market declined during those months, the taxpayer, at the same time the above purchases are made, enters into futures sale contracts for the delivery of equivalent amounts of cotton a few months hence. As the above quantities of spot cotton are subsequently disposed of by sales from time to time of manufactured cotton goods, the above futures sale contracts are con-

currently disposed of by futures purchase contracts which serve as offsetting transactions closing out the futures sale contracts.

(2) The taxpayer makes contracts for future delivery of cotton goods, the manufacture of which will require more cotton than the amount on hand or the amount which can be immediately purchased advantageously. In order to secure protection against a rising cotton market during the months that intervene between the date of the order for cotton goods and the agreed delivery date, the taxpayer, at the same time the above orders are taken, enters into futures purchase contracts for cotton in amounts necessary to provide the desired protection. As the taxpayer from time to time buys spot cotton for the manufacture of the goods specified in the above orders, the futures purchase contracts are disposed of by futures sale contracts which serve as offsetting transactions closing out the futures purchase contracts.

* * * *

The last paragraph of the cited G. C. M. is as follows:

It follows from the above that hedging transactions are essentially to be regarded as insurance rather than a dealing in capital assets within the comprehension of section 117 of the Revenue Act of 1934. Regardless of accounting or inventory methods in use, provisions pertaining to capital gains and losses govern gains or losses on futures contracts which are speculative. Futures contracts representing true hedges against price fluctuations in spot goods are not speculative transactions, though not concurrent with spot transactions. Futures contracts which are not hedges against spot transactions are speculative unless they are hedges against concurrent futures or forward sales or purchases.

Under the interpretation set forth in the cited G. C. M.

the futures contracts in the instant proceeding would not be includable in petitioner's inventories if on hand at the end of the taxable year, for the reason that they are not hedges against actual spot or cash transactions or against forward sales or purchases, as evidenced by a quotation with approval therein from S. M. 5693 (C. B. V-2, p. 20) as follows:

(2) That cotton and grain dealers should incorporate in their balance sheets at the close of the taxable year at market such open future contracts to which they are parties as are hedges against actual spot or cash transactions or against forward sales or purchases, as the case may be; provided, that no purely speculative transactions in futures not offset by actual spot or cash transactions or concurrent forward purchases or sales may be so included or taken into the taxpayer's account in any manner until such transactions are actually closed by liquidation; and provided further, that the values of the commodity covered by such open future contracts shall not be added to or deducted from the inventory of the taxpayer.

In order for petitioner to avail itself of the protective principle of a hedge as that principle is illustrated and enunciated in the cited G. C. M., it must use as a basis the investment risk involved in the cost of its raw material, namely, cottonseed, and relate its futures purchases to that basis. After the manufacturing processes are complete and the resulting product sold, there remains no investment risk against which to hedge.

It is my opinion that petitioner's dealings in futures contracts were not in any sense hedging transactions, and by the very circumstances under which they were consummated they could not possibly be other than purely speculative and could not furnish protection against petitioner's business or investment risks. A hedging transaction is not speculative and eliminates *pro tanto* the speculative character of the investment hedged. It

operates as insurance or protection against the investment risk of future loss and must be entered into for operation covering the period of such risk and terminate therewith. A hedging transaction and the investment protected thereby coexistingly operate upon each other. If a gain is realized on the hedging transaction it is counterbalanced either by a realized loss or by some other character of economic disadvantage in respect of the investment hedged. If a loss is realized in the former it is counterbalanced by a realized gain or some other character of economic advantage in respect of the latter. As a result of the counterbalancing effect between the hedging transaction and the investment protected thereby, speculation as to either gain or loss is eliminated.

It is said in the majority opinion:

> * * * The only purpose which the petitioner had in buying the futures in refined oil was to attempt to avoid loss upon the crude oil which it was manufacturing. This method was as effective a hedge against losses on its operations as was available to the petitioner. * * *

It is my opinion, as hereinabove pointed out, that it was not a hedge and was not of such character as to be effective to accomplish petitioner's claimed purpose. If, however, petitioner's transactions in refined oil futures contracts be deemed a hedge for tax purposes, petitioner with equal logic and effectiveness could have created a hedge by purchasing wheat futures contracts or futures contracts in respect of any other commodity listed on the produce exchange. This illustration is employed merely to indicate the wide open spaces revealed in the majority opinion. The opinion of the Board in this proceeding cites the case of *Ben Grote*, 41 B. T. A. 247, as authority for its conclusion. Regardless of whether the *Grote* case, on its facts, supports the conclusion reached by the majority in this case, it is my opinion that the *Grote* decision is glaringly erroneous. I dissented from it. The opinion

in the *Grote* case did not discuss the question of what constitutes "hedging transactions." It merely said "the evidence shows that petitioner's transactions were all hedging transactions." Aside from that terse *ipse dixit*, no reasons are assigned for the conclusion therein reached.

Subdivision (a) of section 117, *supra*, defines as "capital assets" all property held by a taxpayer except (1) stock in trade of the taxpayer, (2) other property which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, and (3) property held by the taxpayer primarily for sale to customers in the ordinary course of business.

Regardless of whether petitioner's transactions in such futures contracts constituted a trade or business or were entered into for profit, such contracts were nevertheless capital assets within the above statutory definition. They were choses in action, bought and sold only on a produce exchange through brokers. They were bought and sold by petitioner on its own account only, and not for customers. It held no oil futures contracts in stock for sale to customers and, therefore, had no right to include them in an inventory. Cf. *Francis M. Weld*, 31 B. T. A. 600; *Adirondack Securities Corporation*, 23 B. T. A. 61; *Oil Shares, Inc.*, 29 B. T. A. 664; *O. L. Burnett*, 40 B. T. A. 605; *Staerker v. United States* (U. S. Dist. Ct., N. Dist. of Texas, Sept. 23, 1938).

Accordingly the losses involved in this proceeding were capital losses and the deduction thereof should be limited as prescribed in subdivision (d) of section 117, *supra*.

LEECH and HARRON agree with this dissent.

MELLOTT, dissenting: The case of *Ben Grote*, 41 B. T. A. 247, which I feel was decided correctly, does not support

the conclusion of the majority in the instant proceeding. It approves an administrative ruling (G. C. M. 17322, C. B. XV-2, p. 151)—which it may be is not bottomed upon any specific statutory provision—authorizing the deduction of losses in connection with "hedging" operations as "a legitimate form of business insurance."

I agree with much that is said by Mr. Hill in his dissenting opinion. It is obvious that petitioner's dealings in futures in refined oil did not constitute true "hedging" operations in its business. Hedging "is a means by which collectors and exporters of grain or other products, and manufacturers who make contracts in advance for the sale of their goods, secure themselves against the fluctuations of the market by counter contracts for the purchase or sale, as the case may be, of an equal quantity of the product, or of the material of manufacture." *Board of Trade* v. *Christie Grain & Stock Co.*, 198 U. S. 236, 249. In *United States* v. *Coffee Exchange*, 263 U. S. 611, 619, the Court refers to one of the classes who deal in "futures" as "those who use them to hedge, i. e., to insure themselves against loss by unfavorable changes in price at the time of actual delivery of what they have to sell or buy in their business." The examples given in the G. C. M. indicate that when the Commissioner used therein the term "hedging" he had in mind the Court's definition. I would limit the applicability of the ruling to one who has made a counter contract for the purchase or sale of an equal quantity of the product manufactured or raised, or of the material going into the manufacture of it.

Appendix C

TRENTON COTTON OIL CO. v. COMMISSIONER OF INTERNAL REVENUE.

No. 9799.

Circuit Court of Appeals, Sixth Circuit.
February 8, 1945.

On Petition to Review the Decision of the United States Tax Court.

Robert P. Adams, of Trenton, Tenn. (Taylor, Adams & Freeman, of Trenton, Tenn., on the brief), for petitioner.

Helen Goodner, of Washington, D. C. (Samuel O. Clark, Jr., J. Louis Monarch, and Helen R. Carloss, all of Washington, D. C., on the brief), for respondent.

Before HICKS, HAMILTON, and McALLISTER, Circuit Judges.

HAMILTON, *Circuit Judge.*

Petitioner, a Tennessee corporation, is engaged in the business of operating a cotton seed oil mill for the production of crude cottonseed oil and by-products. Its business is seasonal manufacturing operations extending from approximately mid-September to mid-March.

Petitioner acquires the cotton seed from ginners in approximately 100-ton lots graded and carrying a base price subject to adjustment when analyzed upon delivery. It frequently makes loans to ginners in advance of the ginning season conditioned that such borrowers will offer their seed when produced to petitioner at the then market price, petitioner being under no obligation to purchase the seed. On making a firm contract for the purchase of

seed, petitioner estimates the amount of crude oil obtainable and immediately sells the oil to refiners for future delivery at a fixed price. Crude cottonseed oil deteriorates rapidly and if its value is to be preserved it must be refined shortly after production.

Petitioner's plant was not equipped for refining crude oil and its storage facilities were limited to about four and one-half tanks which furnished storage for two weeks' production only. Petitioner kept its accounts and made its income and excess profits tax returns on a fiscal year basis ending August 31st.

Petitioner was uncertain as to the amount of crude oil it could produce from the cottonseed it had contracted to buy and the price it might obtain therefor as the market was unstable. It produced sixty-seven tanks, of approximately 60,000 pounds each, during the operating season of 1938 and 1939. At the beginning of the season, petitioner's board of directors agreed that it would purchase on the Commodity Exchange tanks of refined oil equal to the number of tanks of crude oil sold on the date of the sale of the latter. During the 1938 and 1939 season, simultaneously with the sale of each tank of crude oil, petitioner purchased on margin, for future delivery a tank of refined oil, except that no offsetting purchases were made for the last nine tanks of crude oil sold.

Under the rules of the exchange, refined oil purchased on margin must be delivered within seven months from date of purchase. Petitioner did not receive any of the refined oil, but through its broker, exchanged its contracts for others maturing at a later date, thus maintaining its futures for fifty-eight tanks until September, 1939, when it sold all of them and thereafter made no futures purchases.

On its income tax return for the fiscal year ending August 31, 1939, petitioner showed a net loss of $48,062.85. In determining this loss, it claimed as a deduction

$62,400 the difference between the original purchase price of the refined oil futures and the sum it agreed to pay for replacements at the end of seven months from the date of each original purchase.

In its tax return for the fiscal year ending August 31, 1940, petitioner reported net income of $7,525.66. In determining net income, petitioner showed a profit from the sale of oil futures in the sum of $47,514 which it deducted from the $62,400 loss in the year 1939, leaving a net loss from the sale of futures of $14,886, which sum it deducted from gross income.

Respondent on audit and review determined that the loss sustained by petitioner for the fiscal year ending August 31, 1939, resulted from the sale of capital assets and was allowable only to the extent of $2,000 under Section 117(d) of the Revenue Act of 1938, 26 U. S. C. A. Int. Rev. Acts, page 389, and disallowed the entire loss claimed by petitioner for the year ending August 31, 1940, and included in gross income the entire profit realized by petitioner during the year from the sale of futures. The Tax Court sustained respondent.

The first question for decision is whether the losses sustained by petitioner from the dealings in refined cottonseed oil futures were ordinary and necessary business expenses under Section 23(a)(1) of the Internal Revenue Code, Title 26 U. S. C. A. Int. Rev. Code, § 23(a)(1), or capital losses under Section 117(d)(1) of the Code, Title 26 U. S. C. A. Int. Rev. Code, § 117(d)(1)

[1] Losses from counter contracts made by manufacturers to protect themselves against fluctuations of markets in the purchase of raw material in advance of use, or sales of manufactured goods in advance of production, are treated under the Internal Revenue Statutes as ordinary business expenses, and gains from such sources are treated as ordinary income. Ben Grote v. Com'r, 41 B. T. A. 247; G. C. M. 173.22, XV-2, Cum. Bull. 151 (1936). Purchases

and sales against price fluctuations are insurance against loss and such transactions have a direct relationship to profit realized or loss sustained in the conduct of a business.

[2] Before such a loss may become allowable as a business expense, it must be made to appear that a contract has been entered into for the sale and delivery of a product at a future date and that there is a counter contract for the purchase of the same product for future delivery or one so akin to it that it affects the price of the former. The whole theory is that when the price goes up or down the gain on one transaction will offset the loss on the other. The price relationship, as shown by the evidence, between crude and refined oil is so intimate that the purchase of the latter for future delivery may be used as an insurance against risk of loss on the former sold for future delivery and the same is true as to the price relationship between refined oil and cottonseed.

The real question here is whether petitioner's contracts for the purchase of refined oil futures were made to protect it against loss on the purchases of cottonseed or on the sale of crude oil for future delivery.

The Tax Court found as a fact that petitioner's purchases were not for that purpose. This finding is supported by substantial evidence.

Petitioner's general manager testified that there was a thorough understanding and agreement among its officers and directors that refined oil futures would be purchased and held until such time as the market might reach the point where it would be possible for petitioner to protect or recover against what was considered a loss sustained by it through the sale of the season's production of crude cottonseed oil at unsatisfactory prices. The transactions had none of the characteristics of a protection against loss due to fluctuation in the market of a

product which petitioner had sold for future delivery. It had used the cottonseed which it had purchased at a fixed price and had likewise sold the crude oil at a fixed price when it entered into the contracts to purchase refined oil futures. The transactions in futures have all the earmarks of purchasing and selling for future delivery with a view to profit based on the law of supply and demand or some other economic changes in the industry which would affect prices. United States v. New York Coffee & Sugar Exchange, 263 U. S. 611, 44 S. Ct. 225, 68 L. Ed. 475.

Section 112(a)(b) of the Internal Revenue Code, 26 U. S. C. A. Int. Rev. Code, § 112(a)(b), provides in substance that the entire amount of gain or loss determined under Section 111 of the Code shall be recognized except that neither gain nor loss shall be recognized if property held for productive use in trade or business or for investment is exchanged solely for property of like kind and held for the same purpose. There is excluded from the exception stock in trade or other property held primarily for sale, stocks, bonds notes, choses in action, certificates of trust or beneficial interest or other securities or evidence of indebtedness or interest.

Petitioner contends that when it sold a refined oil futures contract and purchased another for the same quantity of oil for the purpose of maintaining its position in the futures market without the necessity of taking delivery of any oil, the sale was not a closed transaction, but that taxable gain or deductible loss on the sale resulted only when it sold a contract and did not simultaneously purchase another contract for future delivery of a like amount of refined oil.

[3-5] The transactions of petitioner in oil futures are clearly within Section 112(a) unless they come within the proviso of Section 112(b) and are not within its exclusions. It is well settled that the language of the Revenue Act is to be taken in its ordinary meaning unless the context or legislative history of the enactment impels a different

interpretation. Old Colony Railroad Company v. Commissioner, 284 U. S. 552, 560, 52 S. Ct. 211, 76 L. Ed. 484. The Congress must be presumed to use words in their ordinarily known signification. Levy's Lessee v. McCartee, 6 Pet. 102, 31 U. S. 102, 110, 8 L. Ed. 334. The popular or usual import of words furnishes the general rule for the interpretation of public laws. Maillard v. Lawrence, 16 How. 251, 57 U. S. 251, 261, 14 L. Ed. 925.

[6] The purpose of Section 112(b) was to save the taxpayer from an immediate recognition of gain and the tax thereon and conversely to intermit the claim of a loss in exchange transactions where gain or loss may have occurred in a constitutional sense, but where in a popular and economic sense there had been a mere change in the form of ownership or in other words that substance and not form should control in determining whether gain or loss had been realized or sustained. Portland Oil Company v. Com'r, 1 Cir., 109 F. 2d 479.

[7] The context of the Revenue Act and its legislative history give no hint that the word "exchange" as used in Section 112(b) is to be given other than its ordinary meaning. In this sense it means a mutual grant of equal interests, the one in consideration of the other. "Exchange" is a word of precise import, meaning the giving of one thing for another, requiring the transfers to be in kind, and excluding transactions into which money enters either as the consideration or as a basis of measure. United States v. Rodenbough, D. C. Pa., 21 F. 2d 781. The term is almost synonymous with "barter." Postal Tel. Cable Co. v. Tonopah & T. R. R. Co., 248 U. S. 471, 474, 39 S. Ct. 162, 63 L. Ed. 365.

[8, 9] The sale of property and the immediate repurchase of like property is not an exchange, because the basis of the transaction is measured in money. This rule clearly appears where parties, through a common broker, sell property to one person and purchase similar property

from another. The transaction has none of the characteristics of an exchange but consists of two sales. Petitioner's transactions in futures were sales and profit or loss resulted from each transaction depending upon whether petitioner received more or less than the original cost of the futures sold. The purchases of other futures simultaneously with each sale did not result in an exchange.

Section 118(a) of the Internal Revenue Code, 26 U. S. C. A. Int. Rev. Code, § 118(a), provides in substance that no loss shall be allowed from any sale or other disposition of shares of stock or securities where it appears that within a period beginning thirty days before the date of such sale or other disposition and ending thirty days after such date, the taxpayer has acquired or has entered into a contract or option so to acquire substantially identical stock or securities.

Petitioner insists that the repurchase by it of futures contracts simultaneously with the sale of such contracts is controlled by the above section of the Code, and that the new purchases by it within thirty days after the sale took the cost of the old futures sold, and that the losses claimed by it on its original return for the fiscal year ending August 31, 1939, should be disallowed in that year and allowed the following year.

The statute does not define the term "stock or securities", and it is therefore necessary to resort in interpreting the provision to the common and ordinary meaning of these words. The earlier Revenue Acts permitted broadly the deduction of losses on the sale of securities. Under these acts, where a taxpayer made a bona fide sale of securities, although he purchased simultaneously the same securities at the same price, the loss was allowable. The Congress, realizing that loss of revenue was inherent in these transactions, in the 1921 Revenue Act erected the present barrier to their deduction.

The sole purpose of the statute was to prevent the deduction of losses from net income and the Congress set up as a barrier a more or less arbitrary standard to overcome the evil. Unless losses from dealings in commodity futures through a broker are within the statute, the barrier is weakened, because the dealings in such property on exchanges of the country is almost as extensive as that in stocks and bonds.

The whole question turns on the meaning of the word "securities." It may be helpful in arriving at a correct definition to give some thought to the character of the transactions with which we are dealing.

[10] The relationship between petitioner and the broker was that of pledgor and pledgee. Richardson v. Shaw, 209 U. S. 365, 376, 28 S. Ct. 512, 52 L. Ed. 835, 14 Ann. Cas. 981. An assignment of a contract for delivery of refined cottonseed oil on a future day as collateral operates in equity as a contract for a pledge, and the lien attaches to the oil as soon as it comes into existence and possession under the contract. The contracts petitioner made with its broker, although executory at the beginning, were made for the express purpose of being transferred directly or indirectly by further contracts. They constituted evidence of a right to property and they could be assigned and transferred and were security to the broker who had advanced the necessary funds to purchase the oil. The broker held the oil in trust to the extent of its claim and then for the petitioner.

Webster's International Dictionary defines "securities" as "that which secures or makes safe; Specifically, something given, deposited or pledged; to make secure or certain; or certain the fulfillment of an obligation; the payment of a debt; an evidence of debt or of property, as a bond, a stock certificate or other instrument, etc.; a document giving the holder the right to demand and receive property not in his possession." The Oxford English

Dictionary says a "security" is a "document held by a creditor as guarantee of his right to payment; hence, any particular kind of stock, shares or other form of investment guaranteed by such documents." As applied to dealings in property and to commercial transactions, the word "security" under present usage has a generous scope far beyond its literal meaning.

It may be that when petitioner sold futures contracts and repurchased others of a like amount there was a constructive delivery of the cottonseed oil to petitioner and a constructive re-delivery to the broker, but considering the substance of the transactions rather than their form, petitioner had no more than a document giving it the right to demand and receive property not in its possession. This is a security.

[11] We think it is quite clear that petitioner was using the facilities of the Commodity Exchange in its business of buying and selling rights in commodities and that it is equally clear that the Tax Court was correct in holding that the losses petitioner sustained were capital losses subject to limitations of Section 117(d). On the other hand, we think it is just as clear that in those instances where petitioner sold a futures contract and bought a new futures contract for the same quantity of cottonseed oil sold, a wash sale of securities under Section 118 resulted.

In determining taxable income of petitioner for the years in question, the losses or gains sustained or realized by it in the sale and purchases of cottonseed oil futures should be determined under Sections 117 and 118 of the Internal Revenue Code integrated.

The order of the Tax Court is reversed and the cause is remanded for further proceedings consonant with this opinion.

Appendix C

TRENTON COTTON OIL COMPANY, PETITIONER v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 110950. Entered December 28, 1943.

Robert P. Adams, Esq., and Taylor E. Cress, C. P. A., for the petitioner.

Charles P. Bagley, Esq., for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

MELLOTT, *Judge*:

The Commissioner determined the following deficiencies in tax:

Fiscal Year Ending	Income Tax	Excess Profits Tax
August 31, 1939	$1,773.07	.....
August 31, 1940	9,780.50	$5,163.92

Some of the adjustments are not contested. One issue raised by the pleadings involves an expenditure of $65.40 which the respondent determined was a capital expenditure. No evidence was adduced upon this issue. All other charges of error arise from the respondent's treatment of petitioner's dealings in futures for cottonseed oil.

Summarizing the charges of error petitioner contends that the respondent erred: (a) in determining that its losses from such dealings in futures were not losses from "hedging" but were capital losses; (b) in determining that each transaction on the Commodity Exchange resulted in taxable gain or loss; and (c) in determining that such losses were not losses from "Wash Sales". (Section 118, Revenue Act of 1938).

Appendix C

FINDINGS OF FACT

Petitioner is a Tennessee corporation located at Trenton, Tennessee. Its books are kept and its returns are made on a fiscal year basis beginning September 1 and ending August 31. Its returns for the taxable years were filed with the collector of internal revenue for the district of Tennessee.

In the taxable years and for many years prior thereto petitioner was engaged in the business of operating a cottonseed oil mill for the production of crude cottonseed oil and by-products, consisting principally of cottonseed meal, cottonseed hulls and linters. The business of crushing cottonseed oil is seasonable, beginning about the middle of September and continuing for six or seven months.

During the taxable years petitioner had two cottonseed storehouses having a capacity of between 9,000 and 10,000 tons. It purchases and crushes approximately 11,000 tons of cottonseed a year. During the crushing season it always has a substantial quantity of cottonseed on hand.

Crude cottonseed oil deteriorates rapidly, especially in warm weather, and has to be refined shortly after it is produced. Petitioner had no facilities for refining crude oil and its storage capacity for crude oil was quite limited, being only approximately 4½ tanks, equivalent to approximately 2 weeks' production. It is impractical either to store the crude cottonseed oil, or, in a small mill like petitioner's, to have it refined.

Petitioner's purchases of cottonseed are not all made at one time. Most of its seed is purchased from ginners in quantities of approximately 100 tons at a time. The cottonseed is bought on grade at a "basis" price which is subject to adjustment when the seed is analyzed and graded upon delivery. Petitioner also, in advance of

the cotton season, frequently makes loans to ginners in order to get their cottonseed. When such loans are made it is understood that the ginners will offer their seed to petitioner at market before disposing of it elsewhere; but petitioner is not thereby committed to purchase any quantity of such seed.

As petitioner purchases cottonseed, it determines the quantity and grade of crude oil which will be produced therefrom and usually sells the oil for delivery as produced at a fixed price.

In the season 1938-1939 petitioner produced 67 tanks of crude cottonseed oil. At the beginning of the season the price was unsatisfactory and was recognized by petitioner and its officers and stockholders to be unsatisfactory. The situation was discussed by petitioner's officers and its 7 stockholders and decision was reached to purchase on margin on the Commodity Exchange substantially an equal number of tanks of refined oil for future delivery. It was agreed that petitioner would maintain its "long" position in refined cottonseed oil until such time as the prices for its crude cottonseed oil became satisfactory. There is no futures market for cottonseed or for crude cottonseed oil.

Under the rules of the Commodity Exchange futures contracts for refined cottonseed oil are limited to 7 months. The only way petitioner could maintain its "long" position over a period of time greater than 7 months was to dispose of its contracts prior to the delivery date and acquire other contracts calling for the future delivery of a like amount of refined oil in a later month. This was accomplished by means of "switching" through the brokers.

A "switching" requires that the brokers either find somebody who is willing to take, for example, 10 tanks of May delivery in exchange for 10 tanks of September delivery or that the 10 tanks, the date for delivery of

which is approaching, be sold on the market and 10 tanks for delivery at a later date be purchased. Such transactions are always treated by the brokers as a purchase and sale, are so shown on the broker's statement to the customer and a commission is charged by the broker.

A tank of crude cottonseed oil consists of approximately 60,000 pounds. As sales were made during the 1938-1939 season by petitioner of its crude cottonseed oil an equivalent amount of refined cottonseed oil was bought on the Commodities Exchange for future delivery. This was done in connection with all except the last 9 tanks of crude cottonseed oil produced and sold by petitioner. The sales and purchases were as follows:

Date Crude Oil Shipped	Tanks	Date Futures Refined Oil Bought	Tanks	Maturity of Futures Contracts
10/ 3/38	10	10/ 3/38	10	May
10/19/38	5	10/19/38	5	May
10/28/38	5	10/28/38	5	May
10/31/38	5	10/31/38	5	May
11/ 2/38	5	11/ 2/38	5	May
12/29/38	7	12/29/38	7	July
1/23/39	5	1/23/39	5	July
2/ 6/39	5	2/ 6/39	5	Sept.
2/23/39	5	2/23/39	5	Sept.
2/27/39	6	2/27/39	6	Sept.
Total	58 Tanks		58 Tanks	

As the maturity dates of the futures contracts approached petitioner requested its broker to "switch" such contracts to contracts maturing at a later date. The details of these transactions are not shown in the present record. Petitioner was required to maintain a margin of $300 per tank on its purchases of refined oil and, as the price declined, it was required to make additional

deposits. The gain or loss on each sale was reflected in petitioner's account on the books of the broker; but neither the books nor copies thereof are in evidence.

In dealing in futures on the Commodity Exchange when a futures contract is sold by the broker the proceeds are credited to the account of the customer and any credit then shown in the account may be withdrawn by the customer. If contracts for delivery at a later date are purchased, they may be paid for at that time or they may be carried on margin. Final settlement is made when the contracts are sold or fulfilled.

In September of 1939 (during the fiscal year ending August 31, 1940) petitioner sold the 58 tanks of refined oil which it had purchased for future delivery and thereafter made no further purchases of futures.

The losses sustained by petitioner in connection with the "switching" of its position during the fiscal period beginning September 1, 1938 and ending August 31, 1939 amounted to $62,400. On its income tax return for that period petitioner deducted $62,400, reporting on its income tax return for that period a net loss of $48,062.85. In determining the deficiency in tax for that period the respondent determined that the losses resulted from the sale of capital assets and were allowable only to the extent of $2,000 under Section 117 (d) of the Revenue Act of 1938.

The contracts acquired by the petitioner through the "switching" operations in the earlier fiscal year, owned by it at the beginning of the latter fiscal year, and sold by it during that period, resulted in a profit to petitioner of $47,514.

In its return for the fiscal year ending August 31, 1940 petitioner reported net income of $7,525.66. In preparing its return for this period petitioner offset against the profit realized from its dealings in futures during that

period—$47,514—the loss which had been sustained in the earlier period—$62,400—and deducted from gross income the difference between these amounts, i. e., $14,886 as a loss. The deduction was disallowed by the respondent, the $47,514 was included in gross income and other adjustments were made which are not now in issue.

Opinion

As indicated at the outset petitioner contends that its purchases and sales of refined cottonseed oil were "hedges". The essence of its argument upon brief may be gleaned from the following excerpt:

> * * * On account of the unsatisfactory market conditions of seed and crude oil prices, petitioner sold its crude oil, when the seed that produced it was bought, and the crude oil was actually delivered, as sold. Having seed on hand to be processed and being committed to accept future seed at an undetermined price, every time petitioner sold its crude oil, it did not place orders for future purchases of refined oil, but it actually bought, at the same time of its sale, a specified number of tanks of futures refined oil at a then and there designated price, to protect and insure itself against an equal number of tanks of crude oil to be later manufactured; and at no time did petitioner sell crude oil and then, at a later date, purchase futures contracts of refined oil. When it sold 10 tanks of crude oil at a definite fixed price knowing that it would manufacture, from seed on hand and seed for which it was committed, another 10 tanks of crude oil, which it had to sell, petitioner, then and there, bought at a fixed, definite price 10 tanks of futures refined oil.

Paradoxically both parties rely upon Commissioner v. Farmers & Ginners Cotton Oil Co., (CCA 5) 120 F.

(2d) 772, certiorari denied 314 U. S. 683. This case originated before the Board of Tax Appeals, which, after promulgating a decision sustaining the Commissioner's view that futures contracts were capital assets and the losses resulting therefrom were deductible only to the extent allowed by the capital gain and loss provisions of the statute (Farmers & Ginners Cotton Oil Co., 41 BTA 255), reversed the holding of the Division (idem 41 BTA 1083) several members dissenting, and held that the dealing in futures was a "hedge." The Circuit Court of Appeals reversed. Petitioner attempts to support its theory—which seems to be that the "hedge" was against cotton seed rather than against crude cottonseed oil—by quoting several excerpts from the opinion of the court. Thus it says the facts are entirely different because it had not followed what the court referred to as "the customary practice" of the taxpayer in the cited case, "to sell the crude oil at the prevailing market price and then to place orders [sometimes weeks later] with brokers to purchase futures * * *." Also "it [Farmers & Ginners Co.] sold crude and bought refined when it had no actual commodity on hand or future commitments to be protected from price variations. * * * It had no crude or refined oil on hand when it bought or sold the futures from which the losses in controversy were incurred." These quotations, petitioner insists, "seem to say that if the Farmers & Ginners Cotton Oil Company had actual commodity on hand and had actual commitments to be protected against, that it would amount to a true 'hedge'." We do not agree.

A hedge, as the court pointed out, "is a form of price insurance; it is resorted to by business men to avoid the risk of changes in the market price of a commodity. The basic principle of hedging is the maintenance of an even or balanced market position." It is "a means by which collectors and exporters of grain or other products, and manufacturers who make contracts in advance for the

sale of their goods, secure themselves against the fluctuations of the market by counter contracts for the purchase or sale, as the case may be, of an equal quantity of the product, or of the material of manufacture." Board of Trade v. Christie Grain & Stock Co., 198 U. S. 236, 249. "To exercise a choice of risks, to sell one commodity and buy another, is not a hedge; it is merely continuing the risk in a different form." Commissioner v. Farmers & Ginners Cotton Oil Co., supra. While we are of the opinion that is what petitioner did, we will analyze its contention more fully in the light of the evidence adduced.

Petitioner upon brief refers to its "commitments" for cotton seed. While it is clear it had to have cotton seed if it expected to carry on its crushing business, it is far from clear that it ever had any real "commitments" for the purchase of seed other than its contracts with ginners for the purchase, at market, of 100 ton lots. "The basis price would be fixed on that 100 tons. When he delivered that possibly he would sell some more." Nor can any real "commitments" be spelled out of the loans made by petitioner to the ginners. Petitioner merely agreed to loan them money if they would bring their seed to it; but it "had no agreement as to what price it would pay" when the money was loaned. "No agreement as to price; it would be at the market at the time they delivered the seed." Nor is there any evidence from which it could be determined that petitioner always had on hand, at the time each future was purchased, sufficient seed to manufacture an equal quantity of crude oil. However that may be, it is clear petitioner decided to purchase futures, not because of the price of cotton seed or its commitments to purchase cotton seed but because of the "unsatisfactory crude oil prices." When its responsible officer, testifying as a witness, was asked whether the purpose of the company in purchasing the futures was to protect it against what it had sold or had to sell (crude oil) or to protect the seed it had contracted to

buy; he said "Both." As we view it, the distinction, if any, between the present facts and those before the court in the Farmers & Ginners case is so small as to be practically negligible.

In our judgment petitioner has failed to prove that its dealing in futures was a true "hedge". On the authority of Farmers & Ginners Cotton Oil Co., supra, decision must be entered limiting its loss in the fiscal period ending August 31, 1939, to $2,000 unless a different result is justified under some theory not yet considered.

Petitioner contends that taxable gain or deductible loss from its transactions resulted only when, upon closing out a contract for the future delivery of refined cottonseed oil, it did not simultaneously acquire another similar contract. It also contends that the losses from its "switching" are not recognizable because of the "Wash Sales" provisions of the statute.[1]

Transactions in commodity futures are commonly referred to either as a purchase and sale of specific commodities, or a purchase and sale of contracts under which the trader acquires a right to the specific commodity. In either view there is a purchase and sale of property. George W. Covington, et al., 42 BTA 601, affirmed on this point Commissioner v. Covington, 120 F. (2d) 768, certiorari denied 315 U. S. 822. The petitioner, having purchased futures, could demand delivery of the com-

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[1] SEC. 118. LOSS FROM WASH SALES OF STOCK OR SECURITIES.

(a) In the case of any loss claimed to have been sustained from any sale or other disposition of shares of stock or securities where it appears that, within a period beginning 30 days before the date of such sale or disposition and ending 30 days after such date, the taxpayer has acquired (by purchase or by an exchange upon which the entire amount of gain or loss was recognized by law), or has entered into a contract or option so to acquire, substantially identical stock or securities, then no deduction for the loss shall be allowed under section 23 (e) (2); nor shall such deduction be allowed under section 23 (f) unless the claim is made by a corporation, a dealer in stocks or securities, and with respect to a transaction made in the ordinary course of its business.

modity or sell its right to the commodity to another. It therefore makes no difference whether the transaction was closed by an exchange of warehouse receipts or without that formality. In legal effect there was a delivery of the commodity sold Board of Trade v. Christie Grain & Stock Co., supra; Lyons Milling Co. v. Goffe & Carkener, Inc., 46 F. (2d) 241. It must be assumed that the gain or loss incident to the sale and all charges, including the broker's commissions, were reflected in petitioner's account on the books of the broker and on the statement which it sent to the petitioner. While the statements are not in evidence the broker testified, and we take judicial notice of the fact, that at any time a sale was made petitioner could have drawn down any resulting profit. Its losses, if any, likewise then became payable after the margin was exhausted. It is therefore plain that the transaction was closed for income tax purposes and the losses occasioned thereby were incurred in the sale or exchange of a capital asset within the meaning of section 117 of the Revenue Act of 1938. Nor was the character of the transaction changed by the fact that the petitioner, at the time of the sale of refined oil futures, concurrently purchased an equal amount of the same commodity for future delivery. Robert M. Harriss, 44 BTA 999 (on appeal 2 CCA); Valley Waste Mills v. Page, 115 F. (2d) 466, certiorari denied 312 U. S. 681.

Petitioner's contention that its transactions in refined oil futures come within the "Wash Sales" provision of the statute must also be denied. The statute relates only to stock or securities. Here, as has been pointed out, petitioner sold and purchased refined cottonseed oil or a right to such oil, which for present purposes amounts to the same thing. When a sale was made the transaction was closed and taxable gain or deductible loss resulted. Valley Waste Mills v. Page, supra.

The Commissioner committed no error in determining the deficiencies in tax.

Decision will be entered for the respondent.

WHITNEY v. COMMISSIONER OF INTERNAL REVENUE

No. 5323

Circuit Court of Appeals, Third Circuit.

October 3, 1934.

Petition for Review from the United States Board of Tax Appeals.

Petition by Richard Whitney to review an order of the Board of Tax Appeals redetermining a deficiency in the tax imposed by the Commissioner of Internal Revenue.

Order of redetermination modified in accordance with opinion.

Frederic E. Mygatt, Jr., of New York City, for petitioner.

Frank J. Wideman, Asst. Atty. Gen., and Sewall Key and Carlton Fox, Sp. Assts. to Atty. Gen., for respondent.

Before DAVIS, Circuit Judge, and CLARK and JOHNSON, District Judges.

DAVIS, Circuit Judge.

This petition for review involves a deficiency in income taxes for the year 1927. The questions here are whether or not the petitioner may deduct from his gross income

certain dues and contributions paid, as a member, to the New York Stock Exchange and losses sustained in operating a racing stable.

During 1927, the petitioner was a partner in the brokerage firm of Richard Whitney & Co. He and two other partners were members of the New York Stock Exchange. The rules of the Exchange required individuals to own seats, but permitted an individual to assign his seat to his firm for its use. This was done by the petitioner and his partners and, under the partnership agreement, the firm paid all the dues and assessments on the seats owned by the firm members.

In 1927, Richard Whitney & Co. paid a total of $1,981.86 to the Exchange on behalf of the three seats held by its members. Of this amount $1,019.83 was the proportion charged to the petitioner by the partnership under the agreement that all charges of the Exchange on members' seats should be paid by the partnership. It should be noted that this sum charged to the petitioner does not represent the dues and assessments on the seat owned by him, but the share chargeable to him in proportion to his interest in the firm. That is so for the reason that members of partnerships are assessed for income tax on their distributive shares of the net income of the partnership. Section 218, Revenue Act 1926 (26 USCA § 959).

From the record it appears that the Stock Exchange charged the petitioner a total of $970 for his seat in 1927. That amount represents $800 for dues and $170 for contributions to the Gratuity Fund of the Exchange.

The constitution of the Stock Exchange requires each member to pay dues, not to exceed $1,000 annually, to be used for current expenses or capital investment as determined by the Governing Committee of the Exchange or to be subject to suspension or expulsion. The record shows

that the books of the Exchange treated the dues paid by the petitioner as capital contributions.

The constitution of the Exchange provides that each member shall contribute $10 to the family of a deceased member. That is called the Gratuity Fund. During 1927, the petitioner was required to make payments of $170 to the fund, but his bills from the Exchange showed a credit in the fund of $79.67 for some reason not appearing, and he therefore made net payments on this account of only $90.33.

The Commissioner and the Board of Tax Appeals held the petitioner accountable in his return for the sum of $1,019.83. The record is not entirely clear, but so far as we understand it, the petitioner's seat was assessed $800 for dues and $170 for contributions to the Gratuity Fund.

The petitioner contends that he is entitled to a deduction of $1,019.83 for ordinary and necessary expenses paid during the taxable year in carrying on his trade or business as a broker, "including * * * rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title." Section 214(a)(1), Revenue Act 1926, 26 USCA § 955(a)(1).

[1] The sum of $1,019.83, which the petitioner claims as a deduction, represents the proportion chargeable to him of the payments made in 1927 by the partnership for the seats assigned to it by the partners. The petitioner, himself, was obligated to the Exchange in 1927 for his own seat for a total of $970, of which $800 was allocated to his seat and $170 to the Gratuity Fund. The difference between the sum charged to him by the partnership and the total of his obligations to the Exchange is $49.83. He is entitled to deduct this difference from his

gross income as an ordinary and necessary expense of carrying on business for 1927.

But the charges against his membership of $970 stand in a different light. The membership was not partnership property. It belonged to the petitioner and was merely used by the partnership.

The petitioner contends that it is immaterial as to what the Stock Exchange does with the dues under section 214(a)(1), which provides that:

"Sec. 214. (a) In computing net income there shall be allowed as deductions:

"(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. * * *"

He says that the government has erroneously read a qualification into this section to the effect that expenses required to be paid as a condition to the continued use of property are not deductible *if the recipient makes a gift or invests any of the payments.*

It is true that the statute is concerned only with the nature of the payments made by the taxpayer and not how the person who receives the payment may choose to use it. The question here is whether or not the several items which total the sum of $970, charged to the petitioner, were ordinary and necessary expenses incurred in carrying on business.

[2] Obviously, the owner of a seat on the Stock Exchange must pay dues and charges. The payments are necessary. But that is not enough. A capital investment may be necessary in carrying on a business. Section 215 (26 USCA § 956) provides that no deductions shall be allowed for "any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." The expense

of business must also be ordinary. That is, it must be a usual or customary expenditure in the course of business during the year. Duffy v. Central Railroad Co. of New Jersey, 268 U. S. 55, 45 S. Ct. 429, 69 L. Ed. 846; Welch v. Helvering, 290 U. S. 111, 54 S. Ct. 8, 78 L. Ed. 212.

[3] The New York Stock Exchange is an association. When the petitioner purchased his seat on the Exchange he made a capital investment. He acquired an interest in the assets of the Exchange as well as the right of trading. The record shows that the dues paid by members were treated in 1927 as capital improvements squarely within the meaning of section 215, which prohibits deductions in such cases.

[4] But in the case of the payments to the Gratuity Fund, a different situation confronts the court. These payments by reason of the petitioner's membership in the Exchange amounted to $170 for 1927. The record shows items amounting to $79.67 were credited against the total of $170, but the petitioner has failed to show the reason for this credit. The balance of $91.33 may be deducted as an expense of carrying on business. These payments were for the benefit of the families of deceased members of the Stock Exchange and were required by its constitution.

The petitioner also contends that he is entitled to a deduction for 1927 from his gross income of $10,326.40 incurred in operating a racing stable.

The issue here is a question of fact: Whether or not the racing stable was operated as a business, or a transaction entered into for profit, though not connected with a trade or business. The Board determined that the losses incurred in operating the stables were personal expenses and that the petitioner's primary motive in carrying on the stables was for the pleasure gained from a hobby.

The petitioner has operated a racing stable since 1918.

There is no information as to the amount of his investment, but his operating expenses generally appear to have increased each year. The evidence shows clearly that the stable was run on a business basis. The petitioner kept books, records, and accounts. He employed trainers, jockeys, and other necessary assistants, and he, himself, supervised and directed the stable, actively and continuously. He has used various methods and experimented considerably to improve his stable. The petitioner has maintained the stable apart, and as a separate business, from his several other enterprises. It is true that the expenses of the stable have exceeded the revenue which is principally derived from prizes, stakes, and the proceeds from sales of horses; but the petitioner testified that he intended and hoped to derive profits from the operation of the stable.

[5, 6] There is no question that a number of racing stables are made as much of a business as the operation of a mercantile establishment and profits are realized thereby. There could be merit in the government's argument, if the facts warranted the conclusion, that racing is the sport of the wealthy, and that the maintenance of a stable is not a business expense but a personal expense. The question is not a philosophical one, but a practical one and involves the determination of whether the petitioner's stable was operated as a business or for pleasure. The Board and this court, in reviewing the order of redetermination, are confined to the facts set out in the record. The burden of proof was on the petitioner before the Board, and if he met it, the burden shifted and the government was required to come forward with evidence to refute the evidence of the petitioner. It did not do so and the Board cannot draw inferences and conclusions from facts or suppositions outside of the record.

The decision of the Board that the petitioner was not

conducting a business was based on the facts that he had not claimed deductions for the losses prior to 1927; that the operation of the stable has not shown a profit from 1918, the year in which it was established; and the assertion that the pleasure in owning a stable was the primary interest of the petitioner.

[7] That the petitioner did not claim a deduction for losses prior to 1927 and that the stable was unprofitable for the eight years it had existed will not support the decision of the Board under the evidence in this case. There is no substantial evidence to support the conclusion that the pleasure of owning the stable was the primary interest of the petitioner in operating it. The evidence in this case is so similar to that in the case of Commissioner v. Widener, 33 F. (2d) 833 (C. C. A. 3); that it is controlling here.

The order of redetermination is modified in accordance with this opinion.

STIMSON MILL CO. v. COMMISSIONER OF INTERNAL REVENUE.

No. 11548.

Circuit Court of Appeals, Ninth Circuit.

July 21, 1947.

Upon petition to review a decision of the Tax Court of the United States.

Petition by the Stimson Mill Company to review a decision of the Tax Court, 7 T. C. 1065, redetermining a deficiency in an excess profits tax imposed by the Commissioner of Internal Revenue.

Decision affirmed.

Bert L. Klooster, of Chicago, Ill., (Chapman & Cutler, of Chicago, Ill., of counsel), for petitioner.

Sewall Key, Acting Asst. Atty. Gen., Helen R. Carloss and Carlton Fox, Special Assts. to Atty. Gen., for respondent.

Before STEPHENS, HEALY and ORR, Circuit Judges.

ORR, Circuit Judge.

The question presented by this petition, is whether §713(e)(1) and §722 of the Internal Revenue Code, 26 U. S. C. A. Int. Rev. Code, §§713(e)(1), 722, in force in 1942, may both be used to determine the excess profits credit of a taxpayer for the year 1942, or whether the two sections are mutually exclusive.

We will refer herein to petitioner as taxpayer, and to respondent as the Government. The facts and the statutory provisions are both lengthy and complex. We therefore set them forth in some detail.

The statutory scheme of the now-repealed excess profits tax was to separate corporate profits earned during the war years into two classes, normal and excess, and to tax each class of profits at different rates.

Under the 1942 law, applicable here, a corporate taxpayer first determined its ordinary net income, or "normal tax income", and then, by additions and subtractions to that figure, not material here, determined its "excess profits net income". From this last item, certain deductions are made, the most important of which is the "excess profits credit". This credit represents the statutory standard of normal earnings. Once this "excess profits credit" is determined it represents the profits (for 1942 in this case) which are subject to the normal tax, imposed at the rate of 40% of such profits. All of taxpayer's earnings

above the "excess profits credit" (with exceptions not material here) are subject to the excess profits tax imposed at the rate of 90% of such profits.[1]

In the computation of a taxpayer's "excess profits credit" we have at least one instance in tax law where a taxpayer desires to have his normal profits as high as possible. For the higher the normal profits the greater the amount of taxpayer's earnings that will be taxed at the 40% rate rather than the 90% rate.

All but a small fraction of the "excess profits credit" is made up in this case by first taking taxpayer's actual earnings for the four years 1936 to 1939, inclusive. § 713(b), I. R. C.

For those four years taxpayer earned the following amounts:

1936	$ 89,422.67
1937	63,706.57
1938	38,127.75
1939	111,839.77
Total,	$303,096.76

Under § 713(e)(1), the earnings in the lowest year (1938) are automatically raised by the "75% rule" to an amount equal to 75% of the average earnings of the other three years. This sum, ($66,242.25 in this case) is required to be substituted for the actual 1938 earnings. Considering this new figure for 1938, taxpayer's total for the four year base period is increased to $331,211.26, and the "average base period net income" is thus $82,802.82. And when we take 95% of this "average base period

[1] Cf. §§ 710, 711, 713, I. R. C., 26 U. S. C. A. Int. Rev. Code, §§ 710, 711, 713. Mertens Law of Fed. Inc. Taxation, § 42.01-3; See footnote 3.

net income", or the sum of $78,662.68, we have computed the excess profits credit. § 713(a)(1)(A).[2]

Therefore, in the absence of any further facts, $78,662.68 of taxpayer's 1942 earnings would be subject to the normal tax and all of its earnings over that amount would be taxed as excess profits at the rate of 90%.[3]

In the instant case additional facts are present. Taxpayer claims relief under § 722 and in pursuance of that claim it is stipulated that taxpayer has established that its normal output was interrupted in 1937 by strikes "* * * events peculiar in its experience, as provided by § 722(b)(1), I. R. C.". The Government has further stipulated that taxpayer has established that its actual 1937 earnings ($63,706.57) were abnormally low, and that "the fair and just amount representing normal earnings which would be used by [taxpayer] as its constructive average base period net income under the provisions of § 722 (exclusive of § 713), for the year 1942 would be determined after reconstructing earnings for the year 1937 * * * from the actual amount * * * to the reconstructed amount of $85,263.34."

Section 722 provides that when a taxpayer establishes (as taxpayer here has done by stipulation) that "the tax computed under this subchapter (without the benefit of this section) results in an excessive and discriminatory tax and establishes what would be a fair and just amount representing normal earnings to be used as a constructive average base period net income * * * *the tax shall be determined by using such constructive average base period net income in lieu of the average base period net income otherwise determined under this subchapter.*" (Italics ours.)

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[2] We shall designate this method of computing taxpayer's excess profits credit as the Government's method.

[3] We have simplified the foregoing discussion of the excess profits tax by eliminating other complicating features of the tax not relevant here.

It is also stipulated that taxpayer is not entitled to any other constructive adjustments to actual earnings under § 722 in the other three base period years.

Under § 722 taxpayer's earnings for the base period considering the reconstructed figure for 1937 would be:

1936	$ 89,422.67	
1937	85,263.34	(reconstructed earnings under § 722)
1938	38,127.75	
1939	111,839.77	
Total	$324,653.53	
Constructive average base period net income:	$ 81,163.38	
95% of above sum (excess profits credit)	$ 77,105.22	

By this method of computing the excess profits credit (and to which method we shall refer as Method 2) where § 722 alone is used without raising the 1938 earnings by the 75% rule of § 713(e)(1), taxpayer receives a lower excess profits credit than if the Government's method is adopted. Notwithstanding the fact that taxpayer has established its right to constructive earnings of $85,263.34 for 1937 under § 722, and its right to use a "constructive average base period net income *in lieu* of the average base period net income", the Government has allowed use of the "average base period net income" under § 713(e)(1), and the latter, or Government's, method of computing the excess profits credit is to taxpayer's advantage.

Thus far there is little dispute. Neither side desires to use Method 2. The crux of this case, however, lies in taxpayer's contention that it is entitled to use *both* § 722

to raise its 1937 earnings, *and* § 713(e)(1) to raise its 1938 figures. By this third, or taxpayer's method, as we shall hereafter refer to it, taxpayer's earnings for the base period years would be:

1936	$ 89,422.67	
1937	85,263.34	(reconstructed under § 722)
1938	71,631.44	(raised under 75% rule of § 713(e)(1))
1939	111,839.53	
Total	$358,157.22	

The average of this total is $89,539.31, and 95% of that sum, or the excess profits credit, is $85,062.35, rather than the $78,662.68 allowed by the Government's method.

It is apparent that taxpayer's method requires *first*, the use of § 722 to raise the 1937 figures, and, *second*, the use of § 713(c)(1) to raise the 1938 figures, since one of the three years used to obtain the new 1938 figure is the reconstructed (not the actual) figure for 1937 obtained by the use of § 722.

The solution of this case resolves itself into a problem of statutory construction, the key to which lies in determining whether, in computing the "constructive average base period net income" under § 722, the 75% rule of the "average base period net income" of § 713(e)(1) may also be used, or whether the two are mutually exclusive.

The Government determined a deficiency of $2,106.08 in taxpayer's excess profits tax liability for the year 1942 as a result of denying taxpayer's claimed relief under § 722. Resort was had to the Tax Court. In sustaining the Government's contention that court placed its decision on two grounds: First, that § 713(e)(1) does not permit

the use of earnings constructed under § 722 for any of the three years of the base period used in raising the lowest year; and, second, that § 722 provides that the "constructive average base period net income", computed under that section shall be used "in lieu of" the "average base period net income", computed under § 713(e)(1).

The Tax Court concluded that petitioner had failed to establish that relief afforded by the use of § 713(e)(1) alone, and allowed by the Government, was less than a "fair and just amount representing normal earnings * * *" and therefore held that the Government had correctly determined taxpayer's excess profits tax liability for 1942.[4]

[1] At the outset of our consideration of this case we are met by the Government's argument that § 732(c) deprives us of jurisdiction to review the determination of the Tax Court.

Section 732(c) provides:

"If in the determination of the tax liability under this subchapter the determination of any question is necessary solely by reason of section 711(b)(1) (H), (I), (J) or (K), section 721, or section 722, the determination of such question shall not be reviewed or redetermined by any court or agency except the [Tax Court]."

In James F. Waters Inc., v. C. I. R., 160 F. 2d 596, we held that § 732(c) is valid, and that Congress may preclude judicial review of the determinations of the Tax Court in respect to statutes such as § 722 which create special relief provisions "reminiscent of sovereign gracious clemency" Pohatcong Hosiery Mills, Inc., v. C. I. R., 3 Cir., 162 F. 2d 146, 149. We think the determination of the question before the Tax Court involved both § 722 and § 713(e)(1).

[4] See also The Homer Laughlin China Co., 7 T. C. 1325, where the same result was reached on virtually identical facts.

It is of course possible to cast the problem, as the Government has done, solely in terms of § 722 by stating that taxpayer was allowed the benefits of § 713(e)(1) and that the only question is whether he is entitled to § 722 relief. But the nature of the § 722 relief sought by taxpayer should not be overlooked. Taxpayer concededly has established, under § 722, that its earnings for the year 1937 should be raised. Averaging said constructive 1937 earnings with taxpayer's actual earnings for the other three years of the base period (since taxpayer is not entitled to raise constructively its earnings for those other three years) would result in its excess profits credit being less than if its 1938 earnings are raised under § 713(e)(1) and its 1937 earnings are left unaffected by § 722.

Taxpayer asks to raise both 1937 and 1938 earnings by the use of both sections. It was this double relief that the Government refused to allow, and the determination of that question clearly was necessary by reason of both sections. For were it not for § 713(e)(1) taxpayer could have no question as to his tax liability to be determined.

By stipulation he established the right to raise the 1937 figures under § 722, and by stipulation he was not entitled to raise other years under that section. The determination of his tax liability can be resolved only by the determination of a question arising under both sections, namely, whether taxpayer may raise his 1938 earnings under § 713 (e)(1) by using the constructive earnings of one year computed under § 722.

The Government concedes that "there is here involved only the question whether the § 722 construction should reflect the § 713(e)(1) adjustment."

It is true that § 722(d) requires a taxpayer to compute his tax without applying § 722, but while this may be an argument in favor of the Tax Court's decision, since taxpayer's method requires him to use § 722 before using

§ 713(e)(1), it is not an argument that the determination of the question is solely necessary by reason of § 722.

As indicated in Waters v. C. I. R., supra (160 F. 2d 598), we think that Congress, in enacting § 732(c), was "motivated by practical considerations in limiting review of issues * * *", raised under the section set out in § 732(c), and that the principal concern of Congress was that the abnormalities and unusual factual circumstances which give rise to relief under those sections should all "be decided by one group familiar with the problems involved." House Report 2333, 77th Congress, 2nd Session, quoted in Waters v. C. I. R., supra, footnote 7.

[2, 3] As to the scope of our review aside from § 732(c), we think we have here a pure question of law, and while we "attach weight to the decision of points of law by an administrative body having special competence to deal with the subject matter" (Dobson v. C. I. R., 320 U. S. 489, 502, 64 S. Ct. 239, 247, 88 L. Ed. 248), we nevertheless have jurisdiction to review "rules of general applicability [announced by the Tax Court] on clear-cut questions of law." Crane v. C. I. R., 67 S. Ct. 1047, 1055; Pohatcong Hosiery Mills v. C. I. R., supra.

[4] Turning to a consideration of the merits of this controversy, the answer to the problems lies (1) in the fact that two separate statutory concepts are involved, namely, "average base period net income" set out in § 713(e)(1), and "constructive average base period net income", found in § 722; (2) that in the event conditions permitting the use of the second concept are present, it is to be used "in lieu of" the first; and (3) that, therefore, both concepts cannot be used together.

The difference between the two concepts is revealed more clearly when it is remembered that the "average base period net income" is computed under § 713(e)(1) by automatic and inflexible methods. If certain conditions are

present (as they were here) the earnings for the lowest year are raised to an amount equal to 75% of the average of the other three years. This is always done, regardless of what caused the low earnings in the one year.

On the other hand "constructive average base period net income" is established by the *discretionary* use of rules and methods thought to be the best way of correcting abnormal and unusual events, peculiar to the individual taxpayer's experience.[5]

The earnings of virtually all corporations may have been low in 1938; if so, all are raised under § 713(e)(1). But because of the flexible methods available in § 722 cases, elements personal to the taxpayer may be considered and its true normal earnings may be more accurately measured.

Section 722 requires that a taxpayer not only show that the tax (computed without benefit or application of § 722) results in an excessive and discriminatory tax,[6] but he must also establish "what would be a fair and just amount representing normal earnings to be used as a constructive average base period net income for the purposes of an excess profits tax based upon a comparison of normal earnings and earnings during an excess profits tax period. * * *"

When no abnormalities have occurred in the base period,

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[5] See, E. P. C. 13, April 9, 1947, published in I. R. Bulletin No. 9, May 5, 1947, and P-H 1947 Fed. Tax Service, Par. 76,148. In this E. P. C., commenting on the Tax Court's decision in the instant case, it is said that in certain cases, parts of § 713 may be used in § 722 cases: "For example, the base period prescribed by § 713(b) is a device which is practical and appropriate to the determination of such a standard of earnings [the normal earnings of § 722], but the 75% rule, having no relationship to cause and effect, is not appropriate and will not be applied."

[6] Under § 722(b) the tax is considered excessive and discriminatory if it is shown, as taxpayer has shown here, that an event unusual in its experience occurred during the base year. Therefore, taxpayer has met the first requirement.

or other events unusual and peculiar in the experience of the taxpayer, then the averaging methods of § 713(e)(1) will produce a satisfactory method of determining average base period earnings. But if the taxpayer has had some abnormal events in its base period (such as the 1937 strike here), then taxpayer is required by § 722 to establish that which would be a fair and just amount representing normal earnings. That is a different concept than the automatic statutory formula of § 713(e)(1), which may or may not represent a "fair and just amount", since it requires an inflexible raising of the lowest year.

Taxpayer argues that there is no evidence that an average computed under § 713(e)(1) is *not* a fair and just amount. Conceding this to be true and that it is theoretically possible to use both sections, the fact remains that Congress has clearly provided in § 722 that a taxpayer must establish what *is* a fair and just amount representing normal earnings which he must then use as a "constructive average base period net income in lieu of the average base period net income otherwise determined under this subchapter." The only place the "average base period net income" is "otherwise determined [in the] subchapter" is § 713(e)(1).

There is no statutory authorization for using the 75% rule of § 713(e)(1) in computing the constructive average of § 722. On the other hand, we think there is a statutory prohibition against using both sections in that § 722 requires the constructive average to be used in lieu of the § 713 average.

[5] Here taxpayer has established what would be a fair and just amount representing normal earnings *for the year* 1937. He contends he may also raise his 1938 earnings by § 713(e)(1), but that which is automatically raised may not be a fair and just amount, and one must be used in lieu of the other. Our remaining inquiry is, what

constitutes the "fair and just amount representing normal earnings" which is to be used in lieu of the § 713(e)(1) average?

It seems clear that it means the *actual* earnings for each year in which no abnormality occurs, *and* the constructive earnings for years in which abnormalities, etc., within § 722* do occur, averaged together. This is the *constructive* average base period net income, and it is to be used in lieu of the § 713(e)(1) average which is designed to relieve automatically taxpayers who have no abnormalities or other events within § 722,* but who do have a year of low earnings.

The regulations covering this subject (S 35.722-2(b)(1) of Regulations 112) provide:

"§ 722(a) provides for the determination of a constructive average base period net income * * *. Therefore, in computing such amount a taxpayer is not entitled to use the rules provided by § 713(e)(1). * * * Since the constructive average base period net income is the fair and just amount representing normal earnings and will reflect adjustments for abnormally low base period years, a taxpayer having computed such amount is not entitled in addition to apply the rules provided by § 713(e)(1)."

These Regulations set forth a reasonable and correct interpretation of the law and taxpayer's contention that the Regulations are invalid cannot be sustained on any of the grounds urged.

Taxpayer assails the decision of the Tax Court on several additional grounds, which, insofar as it is necessary to consider them, may be summarized as follows:

1. § 722(b) "entitles" a taxpayer to use § 713.
2. By the 1942 amendments to § 722 Congress did not

* Shown as § 732 in 163 F. 2d 269, 275.

intend to deprive a taxpayer of his right, which existed under the 1941 Act, to use both § 713 and § 722.

3. The two sections are in pari materia, and must be construed together so as to give full effect to both.

4. The constructive average must be used since taxpayer has established the two conditions precedent to the use of § 722.

[6] First: Taxpayer's contention is that § 722(b) by providing that "The tax computed under this subchapter * * * shall be considered to be excessive * * * in the case of a taxpayer entitled to use the excess profits credit based on income pursuant to section 713 * * *", entitled it to use § 713.

We do not so read § 722(b). It merely provides that it applies to a taxpayer who is entitled to use the excess profits credit based on income, pursuant to § 713. There are two methods of computing excess profits credit: the income method, and the invested capital method (§ 714, et seq.). Not all taxpayers are *entitled* to use the "excess profits credit based on income", i. e., the income method. Under § 712, only domestic corporations in existence prior to January 1, 1940, are "entitled to use" both the income method of § 713 and the invested capital method. Other domestic corporations, and all foreign corporations must use the invested capital method.[7]

Section 722(b) is not authority for the proposition that a taxpayer is entitled to use both § 713(e)(1) and § 722; it merely refers to those corporations which are entitled to use the income method of § 713.

Second: It is true that § 722 in the 1941 Act did provide that the average base period net income, then to be determined under § 722 should be computed as in § 713.

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[7] Cf., Bickford, "Excess Profits Tax Relief", pp. 21, 22; 1944, Prentice-Hall.

It is also true that the 1942 version of § 722 entirely omitted this provision and instead required a "constructive average" to be used "in lieu of" the § 713 average.

Under these circumstances, and with such a drastic alteration of the law, a comparison of the two acts warrants the conclusion that Congress which, in 1941, had permitted the two sections to be used together, declared in 1942 that the sections were mutually exclusive.

[7] Taxpayer cites committee reports to show that the 1942 amendments were designed to broaden the relief granted under § 722; and cases holding that the repeal and simultaneous reenactment of substantially the same statutory provisions are to be construed as a continuation of the old statute. The statute being clear resort to extrinsic aids to construction is unnecessary.

It is contended that the "in lieu of" clause of § 722 leaves unanswered the question of whether the constructive average is an ordinary arithmetical average or an average computed under § 713(e)(1). We do not agree. The constructive average of § 722 is to be used in lieu of the § 713(e)(1) average; hence it cannot be the same average as that called for in § 713(e)(1).

Taxpayer also contends that the "in lieu of" clause means that constructive "earnings" are to be used in lieu of the actual earnings of § 713. But § 722 does not so read. To adopt taxpayer's argument would do violence to the statutory language found therein.

Third: Having held that § 713(e)(1) and § 722 refer to entirely different and mutually exclusive statutory concepts, it follows that rules relating to statutes in pari materia are not material. We repeat that the construction we adopt gives effect to § 722 when a constructive average is to be used, and to § 713(e)(1) when an average is to be used.

Fourth: Taxpayer argues that since it has established

both conditions precedent for the use of § 722, the tax must be determined by the constructive average. With this we agree.

But taxpayer goes further and contends that the constructive average must be computed in accordance with § 713(e)(1) because taxpayer will otherwise be left with a tax which the statute declares to be excessive and discriminatory. With this we do not agree. The fact that taxpayer has shown the abnormality for 1937 entitles it to correct its 1937 figures under § 722. If it does this the excess profits credit, computed without use of § 713(e)(1) turns out to be a lower figure in this case than if the § 713(e)(1) average is used without reference to § 722. But because that is the result of using § 722 alone here, it does not follow that such use of § 722 alone nullifies § 713(e)(1) in all cases, since in other instances where different earnings are involved, the use of § 722 alone would result in a higher excess profits credit than if § 713(e)(1) alone were used.[8]

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[8] See Treas. Dep't. Bulletin on § 722, as amended by E. P. C. 16, June 2, 1947, quoted in CCH Standard Excess Profits Tax Reporter, Vol. 3A—1946, pg. 8337, and pg. 9395-6, wherein it is said:

"Accordingly, the mere existence of an event or circumstance under § 722(b) does not automatically mean that the average base period net income is an inadequate measure of normal earnings. * * * But a taxpayer which has established the existence of one or more of the factors set forth in § 722(b) * * * may be denied relief without a detailed and exact determination of normal earnings when it is clear that without such a determination normal earnings [computed under § 722] would not exceed average base period net income [computed under § 713(e)(1)] * * *.

"There is no test of whether 'average base period net income is an inadequate standard of normal earnings' other than a comparison of average base period net income and constructive average base period net income."

Here a comparison of the two shows that the average base period net income of taxpayer is higher than its constructive average base period net income. It follows, under the Treasury Department Bulletin, that the average base period net income is not "an inadequate standard of normal earnings" in this case.

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Although taxpayer has established an abnormality for 1937 and so should use § 722 in lieu of § 713(e)(1), which is for taxpayers who suffered no abnormalities during the base period, the Government has permitted taxpayer to use § 713(e)(1) instead of § 722.

Other contentions have been made. We have considered them and find them to be without merit.

The decision of the Tax Court is affirmed.

DOWD-FEDER, INC. v. COMMISSIONER OF INTERNAL REVENUE.

No. 10758.

United States Court of Appeals.

Sixth Circuit.

March 28, 1949.

On Petition to Review the Decision of the Tax Court of the United States.

Proceeding on the petition of Dowd-Feder, Inc., to review a decision of the Tax Court of the United States, 10 T. C. 345, redetermining a deficiency imposed by Commissioner of Internal Revenue in petitioner's income tax for 1941.

Affirmed.

M. R. Schlesinger, of Cleveland, Ohio (M. R. Schlesinger, of Cleveland, Ohio, and Grossman, Schlesinger & Carter, of Cleveland, Ohio, of counsel, on the brief), for petitioner.

Carlton Fox, of Washington, D. C. (Theron Lamar Caudle, Ellis N. Slack, Lee A. Jackson and Carlton Fox, all of Washington, D. C., on the brief), for respondent.

Appendix C

Before HICKS, Chief Judge, and SIMONS, and MARTIN, Circuit Judges.

MARTIN, *Circuit Judge.*

Dowd-Feder, Inc., has petitioned this court to review the decision of the United States Tax Court holding that there is a deficiency in the corporation's income tax for 1941 in the amount of $7,885.51. The case involves determination of the proper basis of computation of the taxpayer's excess profits credits.

The Tax Court held that there is no deficiency in excess profits tax for that year; but that where the amount of excess profits credits, computed by using average base period net income reconstructed under section 722 of the Internal Revenue Code, 26 U. S. C. A. §722, is less than the credit resulting from application of the 75 per centum rule under section 713(e)(1) to the actual base period net income, the taxpayer, as is the situation in the case at bar, is not entitled to relief under section 722 in addition to the benefits of section 713(e)(1). This holding was based on the authority of Stimson Mill Co. v. Commissioner of Internal Revenue, 9 Cir., 163 F. 2d 269, certiorari denied 332 U. S. 824, 68 S. Ct. 165, rehearing denied 332 U. S. 839, 68 S. Ct. 218, affirming 7 T. C. 1065. The two pertinent sections of the Internal Revenue Code are, in material part, set forth in the margin.[1] The case was tried in the Tax Court on a stipulation of fact.

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[1] Section 722. "General relief—Constructive average base period net income. (a) General rule. In any case in which the taxpayer establishes that the tax computed under this subchapter (without the benefit of this section) results in an excessive and discriminatory tax and establishes what would be a fair and just amount representing normal earnings to be used as a constructive average base period net income for the purposes of an excess profits tax based upon a comparison of normal earnings and earnings during an excess profits tax period, the tax shall

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[1] From January 1, 1936, to the present time, Dowd-Feder, Inc., of Cleveland, Ohio, has been a distributor of Chrysler and Plymouth automobiles. As the result of a strike at the factories of the Chrysler Corporation from October 6th to November 28th, 1939, deliveries of new cars to its dealers were curtailed, in consequence of which Dowd-Feder, Inc., was unable to procure its normal allotment. The strike and the diminished operations resulting from it were "events unusual and peculiar in the experience" of the taxpayer, within the purview of section 722 of the Internal Revenue Code. Dowd-Feder, Inc., in January 1944, applied for relief under section 722 with respect to the calendar years 1941 and 1942. The taxpayer established to the satisfaction of the Tax Court that, as a re-

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be determined by using such constructive average base period net income in lieu of the average base period net income otherwise determined under this subchapter. In determining such constructive average base period net income, no regard shall be had to events or conditions affecting the taxpayer, the industry of which it is a member, or taxpayers generally occurring or existing after December 31, 1939, except that, in the cases described in the last sentence of section 722(b)(4) and in section 722(c), regard shall be had to the change in the character of the business under section 722(b)(4) or the nature of the taxpayer and the character of its business under section 722(c) to the extent necessary to establish the normal earnings to be used as the constructive average base period net income. (b) Taxpayers using average earnings method. The tax computed under this subchapter (without the benefit of this section) shall be considered to be excessive and discriminatory in the case of a taxpayer entitled to use the excess profits credit based on income pursuant to section 713; if its average base period net income is an inadequate standard of normal earnings because—(1) in one or more taxable years in the base period normal production, output, or operation was interrupted or diminshed because of the occurrence, either immediately prior to, or during the base period, of events unusual and peculiar in the experience of such taxpayer, * * *." 26 U. S. C. A. §722(a) and (b)(1).

Section 713(e)(1). "Average base period net income—general average: The average base period net income determined under this subsection shall be determined as follows: (1) By computing

sult of the Chrysler strike and the resultant interruption of its normal business, its actual earnings for 1939 were abnormally low, and that its actual average base period net income is an inadequate standard of normal earnings under the provisions of section 722(b)(1) of the Internal Revenue Code.

On January 30, 1945, the Commissioner of Internal Revenue issued a statutory notice determining that there is a deficiency in income tax liability of the petitioner for the year 1941 in the amount of $7,885.51, and that there was an over-assessment of excess profits tax liability for that taxable year in the amount of $6,552.18. In making this determination the application of the taxpayer for relief in 1941, under section 722, was partially allowed in the amount of $2,990.97 and disallowed to the extent of $1,933.51. The taxpayer has stipulated and agreed that the determination of the Commissioner that $61,010.60 represents a fair and just amount of normal earnings to be used as a constructive average base period net income, for the purpose of excess profits credit for 1941 only, under the provisions of section 722.

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the aggregate of the excess profits net income for each of the taxable years of the taxpayer in the base period, reduced by the sum of the deficits in excess profits net income for each of such years. If the excess profits net income (or deficit in excess profits net income) for one taxable year in the base period divided by the number of months in such taxable year is less than 75 per centum of the aggregate of the excess profits net income (reduced by deficits in excess profits net income) for the other taxable years in the taxpayer's base period divided by the number of months in such other taxable years (herein called 'average monthly amount') the amount used for such one year under this paragraph shall be 75 per centum of the average monthly amount multiplied by the number of months in such one year, and the year increased under this sentence shall be the year the increase in which will produce the highest average base period net income; (2) By dividing the amount ascertained under paragraph (1) by the total number of months in all such taxable years; and (3) By multiplying the amount ascertained under paragraph (2) by twelve." 26 U. S. C. A. §713(e)(1).

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In its claim for refund of $10,313.57 for 1941, the taxpayer contends that it is entitled to an excess profits credit carry-back of the unused excess profits credit for 1942 in the amount of $29,894.40.[2] The contention is based upon the proposition that the excess profits credit for 1942 should be based upon a constructive average base period net income determined by applying both section 722 and the 75 per centum rule set forth in section 713(e)(1) of the Internal Revenue Code. Using this basis of computation, the petitioner contends that the allowable credit for 1942 should be $66,098.02. The Commissioner denied the contention and disallowed the claim for refund.

The Tax Court found that, in computing its excess profits tax for the taxable years involved, the petitioner is entitled to use an excess profits credit based upon net earnings within the base period years of 1936 to 1939, inclusive, in accordance with section 713 of the Internal Revenue Code, as amended. The Court pointed out that the Commissioner admits that the taxpayer's earnings for 1939 (prior to taxes) should be reconstructed under section 722 from the actual amount of $63,151.29 to the reconstructed amount of $88,338.43; and that the excess profits credit for 1942 would, by calculation, amount to $56,838.71.

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[2] Section 710(c)(3)(A). "Amount of unused excess profits credit carry-back and carry-over (A) Unused excess profits credit carry-back. If for any taxable year beginning after December 31, 1941, the taxpayer has an unused excess profits credit, such unused excess profits credit shall be an unused excess profits credit carry-back for each of the two preceding taxable years, except that the carry-back in the case of the first preceding taxable year shall be the excess, if any, of the amount of such unused excess profits credit over the adjusted excess profits net income for the second preceding taxable year computed for such taxable year (i) by determining the unused excess profits credit adjustment without regard to such unused excess profits credit, and (ii) without the deduction of the specific exemption provided in subsection (b)(1)." 26 U. S. C. A. § 710(c)(3)(A).

But the taxpayer contends that, in addition to the adjustment computed by the Commissioner under section 722, its excess profits credit for 1942 should be computed by the addition of an increase in the excess profits net income for the year 1938, under section 713(e)(1), which would raise the excess profits credit to $66,098.02. The petitioner stipulates and agrees that, unless it is entitled to the adjustment claimed under section 713(e)(1) for the base period year 1938, it is entitled to no further constructive adjustments to actual earnings for the base period years 1936, 1937 and 1938 under section 722 of the Internal Revenue Code as presently constituted.

[2] From the stipulation of facts adopted as findings by the Tax Court, it appears from the calculations therein, and is so declared, that inasmuch as the excess profits credit of $58,620.59, determined by averaging actual base period net income adjusted as to the year 1938 under section 713(e)(1), is *greater* than the excess profits credit computed by the use of an average based on actual excess profits net income for 1936, 1937, and 1938, and excess profits net income for 1939 reconstructed under section 722, relief under that section for the year 1942 should be and is denied.

The petitioner agrees that, if it is not entitled to relief under section 722 of the Internal Revenue Code in addition to the benefits contained in section 713(e)(1) of the Code, in computing the excess profits credit for the year 1942, the proposed deficiency and the over-assessment as set forth in the notice of deficiency of January 30, 1945, are correct and have been properly determined by the Commissioner.

In its opinion, the Tax Court states that the case has been considered in entirety by the Excess Profits Tax Council of the Bureau of Internal Revenue, which, on January 16, 1947, sustained the original determination

set forth in the statutory notice of deficiency issued by the Commissioner on January 30, 1945.

The argument of petitioner here is, upon analysis, the same as that made in behalf of the taxpayer in Stimson Mill Co. v. Commissioner, supra. The contention is that the taxpayer is entitled to obtain the benefits of both section 713(e)(1) and section 722, affording special discretionary relief. As was pointed out by the Court of Appeals for the Ninth Circuit, Congress has provided in section 722 that a taxpayer must establish a fair and just amount representing normal earnings which he must then use as a "constructive average base period net income in lieu of the average base period net income otherwise determined under this subchapter"; and that section 713(e)(1) is the only section of the revenue law where the "average base period net income" is otherwise determined in the subchapter. It is then reasoned, correctly we think, that there is no statutory authorization for using the 75 per centum rule of section 713(e)(1) in computing the constructive average of section 722; but, to the contrary, there is a statutory prohibition against using both sections, inasmuch as section 722 requires the constructive average to be used in lieu of the average provided for in section 713(e)(1). Moreover, we agree with the Court of Appeals that the Treasury Regulations relating to the subject matter constitute a reasonable and correct interpretation of the statutes: "Section 722(a) provides for the determination of a constructive average base period net income. * * * Therefore, in computing such amount a taxpayer is not entitled to use the rules provided by section 713(e)(1). * * * Since the constructive average base period net income is the fair and just amount representing normal earnings and will reflect adjustments for abnormally low base period years, a taxpayer having computed such amount is not entitled

in addition to apply the rules provided by section 713(e)(1)." Section 35.722-2(b)(1) of Regulations 112.

Inasmuch as we are in accord with the basis of decision of the Ninth Circuit and of the Tax Court whose opinion was affirmed, we find no occasion for rewriting and rejecting arguments made by the taxpayer in the instant case which have been considered in detail and rejected in those opinions. In all material aspects relating to the merits we are in accord with the reasoning of the Ninth Circuit upon the points presented.

The Commissioner of Internal Revenue has raised a more troublesome question by his motion to dismiss the petition for review on the ground that this court is without jurisdiction by reason of section 732(c) of the Internal Revenue Code, 26 U. S. C. A. § 732(c), which provides: "Finality of determination. If in the determination of the tax liability under this subchapter the determination of any question is necessary solely by reason of [two specified sections], *or section 722*, the determination of such question shall not be reviewed or redetermined by any court or agency except the Board." [Italics supplied.]

The ensuing section, 732(d), added by the Revenue Act of 1942, provides that the determinations and redeterminations by any division of the Board involving any question arising under section 722 and another specified section, with respect to any taxable year, shall be reviewed by a special division of the Board which shall be constituted by the Chairman and consist of not less than three Board members. The section concludes: "The decisions of such special division shall not be reviewable by the Board, and shall be deemed decisions of the Board." See 26 U. S. C. A. § 732. The Board of Tax Appeals is, as is well known, now the Tax Court of the United States.

The Government argues that no substantial question

has been or may be raised by the taxpayer under section 713(e)(1) of the Internal Revenue Code; and that there is nothing in the wording of that section, its legislative history, or the Treasury Regulations, which warrants the use in a computation made under it of a factor used by the Commissioner in determining whether and to what extent the taxpayer should be granted relief under section 722. It is pointed out that section 713(e)(1) came into the statute in 1942, when Congress enacted substantial changes in section 722; and that, if Congress had intended the interpolation of a special discretionary relief into a general statutory excess profits computation, such intention would have been manifested clearly in the statute. The point is emphasized that Congress, by expression, vested the administration of section 722 in the Commissioner and, by sections 732(c) and 732(d), expressly limited to the Tax Court review of the Commissioner's determinations; and that, by thus entrusting solely to the Commissioner and the Tax Court the grant of relief under section 722, and by the explicit provision that the decisions of the Commissioner and the Tax Court involving questions necessary to be determined solely by reason of that section should not be subject to appellate court review, Congress withdrew jurisdiction to review issues decided by the Commissioner and the Tax Court respecting the grant of relief under section 722.

Arguendo, the conclusion is drawn by respondent that whether a taxpayer may require the grant of relief under section 722 in addition to the benefits to be derived from 713(e)(1), and whether a taxpayer is entitled as a matter of right to read into section 722 the 75 per centum rule of section 713(e)(1), are questions the determination of which depends upon interpretation of section 722, and so are questions the determination of which is necessary solely by reason of section 722.

Appendix C

In support of its argument, the respondent cites a series of special assessment cases arising under statutes pertaining to excess profits taxes, wherein it was held that the federal appellate courts have no power to review determinations of the Board of Tax Appeals when no challenge for fraud or irregularities was made. Welch v. Obispo Oil Co., 301 U. S. 190, 57 S. Ct. 684, 81 L. Ed. 1033; Heiner v. Diamond Alkali Co., 288 U. S. 502, 53 S. Ct. 413, 77 L. Ed. 921; Williamsport Wire Rope Co. v. United States, 277 U. S. 551, 48 S. Ct. 587, 72 L. Ed. 985; Duquesne Steel Foundry Co. v. Commissioner, 3 Cir., 41 F. 2d 995, affirmed per curiam 283 U. S. 799, 51 S. Ct. 491, 75 L. Ed. 1422; Cleveland Automobile Co. v. United States, 6 Cir., 70 F. 2d 365, certiorari denied 293 U. S. 563, 55 S. Ct. 88, 79 L. Ed. 663.

In the last cited case, we reviewed the Supreme Court decisions and drew the conclusion that once the special discretionary power to grant relief under sections 327 and 328 of the Revenue Act of 1918, 40 Stat. 1093, is invoked and exercised, and no claim of fraud or other irregularity is asserted, neither the determination nor the factors used in computation, nor the result itself, is open to review. This court said: "We are not greatly impressed with the argument that the government's view of the special assessment provisions penalizes the taxpayer who resorts to them and compels him to gamble away a right to judicial review specially given him by statute for a blind remedy that may give him much less. The taxpayer is not compelled to invoke the relief sections of the statute. He has his right to judicial relief without resort to them, and whether he seeks such relief or the extraordinary relief which these sections afford, may perhaps depend upon the confidence he has in the merit of his grievance. Moreover, he has still his right of appeal from the findings of the Commissioner to the

Board of Tax Appeals [citing authorities], and such appeal being to an independent agency in the executive branch of the government, especially established to review the Commissioner's decisions, is not in conflict with the view that sections 327 and 328 preclude judicial review of the exercise of administrative discretion. Williamsport Co. v. United States, supra." 70 F. 2d 368.

[3] While the question of our jurisdiction to review the decision of the Tax Court in the instant case is close, we accord due weight to the decision of the Ninth Circuit Court of Appeals in the Stimson Mill Company case, supra [163 F. 2d 273], and have reached the conclusion that we should not depart from its rationale, thus stated: "It is of course possible to cast the problem, as the Government has done, solely in terms of § 722 by stating that taxpayer was allowed the benefits of § 713(e)(1) and that the only question is whether he is entitled to § 722 relief. But the nature of the § 722 relief sought by taxpayer should not be overlooked. Taxpayer concededly has established, under § 722, that its earnings for the year 1937 should be raised. Averaging said constructive 1937 earnings with taxpayer's actual earnings for the other three years of the base period (since taxpayer is not entitled to raise constructively its earnings for those other three years) would result in its excess profits credit being less than if its 1938 earnings are raised under § 713(e)(1) and its 1937 earnings are left unaffected by § 722. Taxpayer asks to raise both 1937 and 1938 earnings by the use of both sections. It was this double relief that the Government refused to allow, and the determination of that question clearly was necessary by reason of both sections. For were it not for § 713(e)(1) taxpayer could have no question as to his tax liability to be determined. By stipulation

he established the right to raise the 1937 figures under § 722, and by stipulation he was not entitled to raise other years under that section. The determination of his tax liability can be resolved only by the determination of a question arising under both sections, namely, whether taxpayer may raise his 1938 earnings under § 713(e)(1) by using the constructive earnings of one year computed under § 722. * * * It is true that § 722(d) requires a taxpayer to compute its tax without applying § 722, but while this may be an argument in favor of the Tax Court's decision, since taxpayer's method requires him to use § 722 before using § 713(e)(1), it is not an argument that the determination of the question is solely necessary by reason of § 722." 163 F. 2d 273. A pure question of law being presented, it was held that the decision of the Tax Court was reviewable by the Circuit Court of Appeals.

The motion of respondent for review is denied; and the decision of the Tax Court is affirmed.

PACKER PUB. CO., v. COMMISSIONER OF INTERNAL REVENUE.

No. 14678.

United States Court of Appeals,

Eighth Circuit.

Apr. 15, 1954.

Charles C. Shafer, Jr., Kansas City, Mo. (Lancie L. Watts, Kansas City, Mo., on the brief; Watts & Shafer, Kansas City, Mo., of counsel), for petitioner.

Harry Marselli, Sp. Asst. to Atty. Gen. (H. Brian Holland, Asst. Atty. Gen., Ellis N. Slack, Sp. Asst. to Atty. Gen., on the brief), for respondent.

Appendix C

Before GARDNER, Chief Judge, and JOHNSEN and COLLET, Circuit Judges.

COLLET, Circuit Judge:

The Packer Publishing Company duly filed its excess profits tax returns for the years 1943, 1944 and 1945. In those returns it did not claim any adjustments under § 711(b)(1)(J) of the Internal Revenue Code, 26 U. S. C. A. § 711.[1] In due time it made claims for refunds under § 711 for all three years. These claims were allowed in part by the Commissioner by stipulation. The taxpayer did not then nor does it now criticize the stipulated allowance. Thereafter, it filed claims for relief and refunds for each of the three years under § 722 of the Internal Revenue Code, 26 U. S. C. A. § 722. The Commissioner disallowed the claims under § 722.

Upon petition by the taxpayer to the Tax Court, that court allowed a portion of the claims by decision reported in Packer Publishing Co. v. Commissioner of Internal Revenue, 17 T. C. 882. The claims based on § 711 having been settled by stipulation between the taxpayer and the Commissioner, neither pleaded the basis for the stipulated allowance in the § 722 proceedings before the Tax Court. The exhibits filed in the Tax Court, made a part of the petition addressed to that court, showed, however, that an allowance had been made under § 711 and the calculations and computations in those exhibits were based upon that stipulated allowance. When the Tax Court granted relief under § 722 it directed that the Commissioner and the taxpayer undertake to make the computation of the amount of refund due and submit the result to the court. This pursuant to the Tax Court's Rule 50. When the Commissioner and the taxpayer undertook to do so, the

[1] Since the pertinent portions of § 711 will be referred to later, they are not set out here.

Commissioner took the position that the taxpayer could not be entitled to relief under both § 722 and § 711 and, since the court had directed relief under § 722, the Commissioner eliminated from consideration the relief theretofore granted by stipulation under § 711. The taxpayer contended that it was entitled to both. Each submitted to the court, under Rule 50, computations based upon its respective position. The dispute was heard by one judge of that court. The record shows that the judge concluded that the court was without jurisdiction to consider whether the taxpayer was entitled to any relief under § 711 in a proceeding for relief under § 722. This decision was made without inquiry into the basis for the claimed relief under § 711. Judgment was entered for the taxpayer upon the computation submitted by the Commissioner. That computation was correct if relief under § 722 necessarily and automatically excluded any relief under § 711. If that premise is not correct, the taxpayer has been denied the relief granted by the Commissioner by stipulation without any opportunity to be heard thereon by the Tax Court.

Also presented to the Tax Court in the § 722 proceeding was a claim for adjustment in the event relief was granted under § 722. Briefly, that claim was based upon the fact that one of the taxpayer's executives was paid upon a bonus agreement, the bonus to be a stipulated portion of net profits after taxes. If relief was granted under § 722, the taxes would be lower and the bonus greater. The claim was that the greater compensation to be paid the executive, in the event the bonus was automatically increased as a result of relief being granted under § 722, be treated as operating expense and the increase deducted from the taxable income of the corporate taxpayer. The Tax Court refused to consider this claim on the ground that it was without jurisdiction to grant such relief in a § 722 proceeding.

The Commissioner now seeks to sustain the Tax Court's

judgment upon the grounds that: (1) the Tax Court's judgment is not reviewable and the Commissioner's motion to dismiss on that ground should be sustained; (2) that if it is reviewable the judgment is correct, because in a § 722 proceeding the Tax Court's jurisdiction is strictly limited to issues arising under § 722 alone; (3) that the taxpayer did not plead the grounds upon which it was claiming the relief theretofore administratively granted by stipulation under § 711 and hence such relief could not be considered in the § 722 proceeding; (4) that in its petition for review of the Tax Court's judgment the taxpayer did not include in the errors assigned or points stated therein any reference to its claim to an increased deduction on account of the increased bonus compensation in the nature of salary to its executive. A motion was addressed to this court, prior to docketing and submission of this cause, for leave to include this additional point for presentation to this court. At that time the motion was denied without prejudice to its renewal at the time of argument and submission. It has been renewed and is before us for determination with the case.

The Commissioner's motion to dismiss is based upon § 732(c), which is as follows:

> "(c) Finality of determination. If in the determination of the tax liability under this subchapter the determination of any question is necessary solely by reason of section 711(b)(1) (H), (I), (J), or (K), section 721, or section 722, the determination of such question shall not be reviewed or redetermined by any court or agency except the Board." 26 U. S. C. A. § 732(c).

Broadly and generally stated, both § 722 and § 711 deal with determining the normal income base to be used for purposes of comparison with the income for the tax year

in question in order to determine the excess profits for a given year which were earned in addition to the normal or base period earnings. This for the purpose of determining the tax for that year. The provision of § 722 under which the Tax Court granted relief is § 722(b)(4), reading as follows:

> "(b) Taxpayers using average earnings method. The tax computed under this subchapter (without the benefit of this section) shall be considered to be excessive and discriminatory in the case of a taxpayer entitled to use the excess profits credit based on income pursuant to section 713, if its average base period net income is an inadequate standard of normal earnings because—
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> "(4) the taxpayer, either during or immediately prior to the base period, commenced business or changed the character of the business and the average base period net income does not reflect the normal operation for the entire base period of the business. If the business of the taxpayer did not reach, by the end of the base period, the earning level which it would have reached if the taxpayer had commenced business or made the change in the character of the business two years before it did so, it shall be deemed to have commenced the business or made the change at such earlier time. For the purposes of this subparagraph, the term 'change in the character of the business' includes a change in the operation or management of the business, a difference in the products or services furnished, a difference in the capacity for production or operation, a difference in the ratio of nonborrowed capital to total capital, and the acquisition before January 1, 1940, of all or part of the assets of a competitor, with the result that the competition of such competitor was eliminated or dim-

inished. Any change in the capacity for production or operation of the business consummated during any taxable year ending after December 31, 1939, as a result of a course of action to which the taxpayer was committed prior to January 1, 1940, or any acquisition before May 31, 1941, from a competitor engaged in the dissemination of information through the public press, of substantially all the assets of such competitor employed in such business with the result that competition between the taxpayer and the competitor existing before January 1, 1940, was eliminated, shall be deemed to be a change on December 31, 1939, in the character of the business, or * * *."

Section 711(b)(1)(J), 26 U. S. C. A. § 711, under which relief was granted administratively by stipulation and later withdrawn by the Commissioner after the Tax Court had granted relief under § 722, is as follows:

"(b) Taxable years in base period.

"(1) General rule and adjustments. The excess profits net income for any taxable year subject to the Revenue Act of 1936 shall be the normal-tax net income, as defined in section 13(a) of such Act; and for any other taxable year beginning after December 31, 1937, and before January 1, 1940, shall be the special-class net income, as defined in section 14(a) of the applicable revenue law. In either case the following adjustments shall be made * * *.

"(J) Abnormal deductions. Under regulations prescribed by the Commissioner, with the approval of the Secretary, for the determination, for the purposes of this subparagraph, of the classification of deductions—

"(i) Deductions of any class shall not be allowed

if deductions of such class were abnormal for the taxpayer, and

"(ii) If the class of deductions was normal for the taxpayer, but the deductions of such class were in excess of 125 per centum of the average amount of deductions of such class for the four previous taxable years, they shall be disallowed in an amount equal to such excess." 26 U. S. C. A. § 711(b)(1)(J).

[1] It is obvious, from the above quoted portions of § 722 and § 711 that the application of the formulae for determining normal or base period income is a complicated process. Reference to the remainder of both sections not quoted herein makes that fact more certain. It is safe to say from the proceedings in Congress incident to the enactment of § 732(c) and the language of the latter section, heretofore quoted, that the congressional intent and purpose was to provide that the application of the formulae set out in § 722 and § 711 (and § 721, not now directly involved) should be finally reviewed by the experts in that field,—the Tax Court. The Commissioner contends that such finality of review by the Tax Court extends not only to the ascertainment of whether the facts in a particular case warrant relief under those sections, but also to the legal construction of those sections for the purpose of determining whether relief granted under § 722 automatically precludes and is in lieu of any and all relief which is provided for by § 711. The cases of Colonial Amusement Co. v. Commissioner, 3 Cir., 173 F. 2d 568; Colorado Milling & Elevator Co. v. Commissioner, 10 Cir., 205 F. 2d 551; George Kemp Real Estate Co. v. Commissioner, 2 Cir., 182 F. 2d 847; James F. Waters, Inc. v. Commissioner, 9 Cir., 160 F. 2d 596, are cited in support of that position.

[2] An examination of these authorities discloses that neither of them holds that a review of the question pre-

sented here is barred by § 732(c). In each of those cases the question determined by the Tax Court was whether, under the facts, relief under § 721, § 722, or § 711 was appropriate. It is true that in the Kemp case the court stated that the language of § 732(c) "forbids any judicial review, whether of fact or law." [182 F. 2d 849.] But that statement was made in answer to a contention that § 732(c) should not be construed to forbid appellate review of questions of law when there were no *disputed* questions of fact. That presented an entirely different situation from that which is before us. There the facts were before the Tax Court. They were considered and the formulae of § 721 and § 722 were applied by that court with the result that it was determined the facts justified no relief under the law. Here the Tax Court declined to consider whether relief was appropriate under § 711, not because the facts did not justify relief, but because that court concluded the proper judicial construction of § 722 and § 711 must result in a holding that the granting of any relief under § 722 automatically precluded any consideration of relief under § 711, and hence no consideration could be given a claim for relief under § 711 in a § 722 case. That decision involved solely the judicial construction of the statute. It did not involve to any extent the determination of whether the formula of the statute, applied to the facts by the experts, justified or did not justify relief. The facts were not before the court and the taxpayer was prevented from presenting them by the court's construction of the statutes. Such a decision of the Tax Court is not within the purview of the prohibition of § 732(c). Cf. Dowd-Feder, Inc. v. Commissioner, 6 Cir., 173 F. 2d 673; Stimson Mill Co. v. Commissioner, 9 Cir., 163 F. 2d 269.

We are not confronted with the necessity of determining the propriety of a denial of relief by the Tax Court under § 711 upon the ground that such relief, if any was

merited, was included in the relief given under the broad scope of § 722, or upon any other ground involving the merits or the facts upon which a claim under § 711 is based. As we have undertaken to make clear, our problem is to determine whether the Tax Court was precluded by § 722 and § 711 from entertaining jurisdiction of the merits of the claim made and granted by stipulation under § 711 in a proceeding instituted under § 722.

[3] Granting that both sections are relief provisions and are to be strictly construed to the end that the relief intended should not be extended beyond the clear intent of the law as written, yet such construction should not be unreasonable or arbitrary.

In Mutual Lumber Co. v. Commissioner, 16 T. C. 370, the Tax Court held (with three judges dissenting) that in a case arising under § 722 it had no jurisdiction to consider an issue other than one arising under § 722. In H. Fendrich, Inc., v. Commissioner, a similar ruling was made. The latter case was reversed in H. Fendrich, Inc., v. Commissioner, 7 Cir., 192 F. 2d 916, decided November 16, 1951. In the case of City Machine & Tool Company v. Commissioner, 6 Cir., 194 F. 2d 535, decided February 22, 1952, the Tax Court had followed the rule it announced in Mutual Lumber Co. v. Commissioner and H. Fendrich, Inc., v. Commissioner. The Commissioner confessed error and the Court of Appeals (6 Cir.) reversed, following H. Fendrich, Inc., v. Commissioner (7 Cir.).

In the case of Jefferson Amusement Co. v. Commissioner, 18 T. C. 44, decided April 9, 1952, and East Texas Theatres v. Commissioner, 19 T. C. 615, decided December 31, 1952, the Tax Court followed the decisions of the Courts of Appeals for the Sixth and Seventh Circuits in the City Machine & Tool Company and the Fendrich cases.

[4] The hearing on the merits of the claim under § 722 was held in November, 1950. The record appears to have been closed April 9, 1951. Although the findings and opinion were not filed until November, 1951, apparently that opinion was rendered before the decision of the Fendrich case, November 16, 1951. When the hearing was held in March, 1952, by the trial judge, on the dispute arising at the conference of the parties under Rule 50, the hearing judge considered the Fendrich case but concluded that the Mutual Lumber case, supra, was the law of this case, the opinion of the Tax Court in the § 722 case having been theretofore filed. Whether the trial judge should have reached that conclusion is of no present importance, for we must now determine the correctness of the judgment of the Tax Court and the decision reached in the Fendrich and City Machine & Tool Company cases, supra, by the Courts of Appeals for the Sixth and Seventh Circuits. We find no fault with those cases. The principle decided in both is correct and controlling here. In both of them those courts reached the conclusion that the Tax Court had jurisdiction to consider issues arising under other parts of the Internal Revenue Code in a proceeding arising under § 722.

The argument is made by the Commissioner that the facts showing the grounds upon which relief was sought (and which had been granted by stipulation) under § 711 should have been pleaded by the taxpayer in its petition to the Tax Court for relief under § 722, and not being pleaded, no relief could be granted under § 711. The taxpayer contends that since the relief under § 711 had been granted by the Commissioner and was no longer in dispute, if the Commissioner considered that relief a bar to or a duplication of the relief sought in the petition for § 722 relief, that fact should have been pleaded as an affirmative defense by the Commissioner and that not having been done, any such defense is now waived.

[5, 6] We are not impressed with the value or desirability of making hard and fast pronouncements concerning procedural practices which experience has taught and formal rules of procedure contemplate should be left sufficiently elastic to enable trial courts to exercise a large degree of discretion in the administration of substantial justice. Formal rules of procedure are necessary and desirable in order that litigants may have an authoritative guide in a proper course to be safely followed to obtain a determination of the merits of their controversy. They should not be made the means of entrapping a litigant, whereby he loses his opportunity to present his cause on its merits. The Tax Court did not do this. It did not reach the question. Since the cause must be remanded, it is sufficient for present purposes to observe that if the formal pleading of additional facts be deemed necessary by the Tax Court for the clarification and presentation of this issue, leave should be granted to make appropriate amendment to the pleadings.

From what has already been said it must follow that the taxpayer's motion for leave to include in the errors assigned the point that the Tax Court had jurisdiction to pass upon the claim for an increased deduction on account of an increase in the compensation of the taxpayer's executive should be granted. It is granted. We agree with the statement of the Senate Finance Committee and the Court of Appeals for the Seventh Circuit in H. Fendrich, Inc., v. Commissioner, 192 F. 2d 916, 920, that:

> "* * * it is essential that all such issues be decided by one group familiar with the problems involved. Only by this method can a consistent and uniform application of the principles established be assured in all cases. At the same time there is provided [by the

statute] flexible machinery to coordinate cases involving both relief and abnormality issues as well as other questions.'"

The petitioning taxpayer requests that we direct the entry of a judgment allowing the relief claimed under § 711. A consideration of the merits of that claim and the facts upon which it is based, in the light of the relief granted under § 722, is essential to a determination of whether relief under § 711 is appropriate, in addition to that granted under § 722. That is for the Tax Court to determine, both from necessity in this case, and also because of the direction of the statute.

For the reasons stated, the cause is remanded to the Tax Court for its determination of the taxpayer's right to relief under § 711, and the propriety of an additional deduction on account of an increase in the compensation of the taxpayer's executive, occasioned by the decrease in taxes resulting from such relief as may be granted by the Tax Court.